



July 25, 2008

Dear Client,

After recuperating from a difficult March which reeled from the stresses in the financial system and included the collapse of Bear Stearns, financial markets during the second quarter of 2008 appeared to be on a recovering trend. Then mid-May arrived; world-wide financial markets retreated again with substantial year-to-date declines in all equity indices. (See Exhibit 9 on page 8). The various reasons for this weakening include, but are not limited to:

- (1) heightened concerns about the health of the US economy;
- (2) a substantial rise in oil prices coupled with the potential impact on global economies and inflationary expectations; and
- (3) a renewed apprehension surrounding the well-being of the US and international banking systems due to their exposure to the US mortgage markets.

Additionally, concerns over the stability of the two mammoth privately-owned US Government Sponsored Agencies, Fannie Mae and Freddie Mac, added to the anxiety over the US financial system.

As we have mentioned in previous letters, during difficult times it is worthwhile to emphasize that a broadly diversified portfolio, a disciplined approach and patience are the most important tools needed to withstand market volatility. Further, it is important to always remember that most investment objectives are long-term, and can best be achieved through the tolerance of short-term volatility.

Human nature reinforces investor behavior that often results in buying high (when the market is exuberant) and selling low (when the market is depressed). Generally, this behavior can be harmful to investors. The process of rebalancing the asset allocation in a client's portfolio attempts to reverse the above behavior by shifting among asset classes during good times, as well as bad times. Where appropriate, and as opportunities present themselves, we continually implement this process. Although we can never know when the market will bottom, for investors with a long-term horizon, the set of investment opportunities presently is ample in most asset classes.

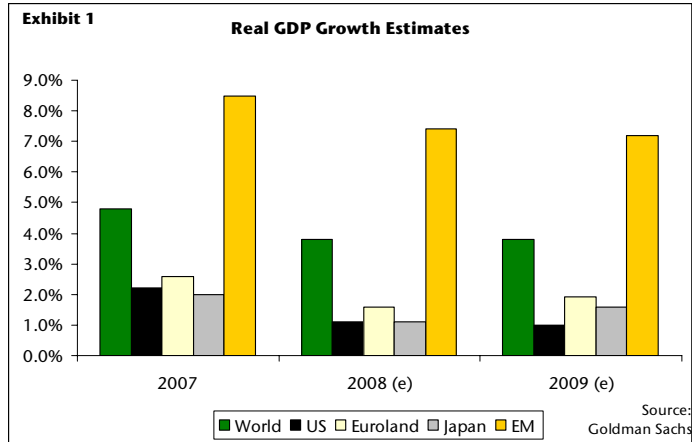
US Economy

The US has been experiencing a gradual deceleration in its economic growth over the last few years. (See Exhibit 1). GDP grew by 2.9% in 2006, slowed to 2.2% in 2007, and is estimated to grow between 1.0% (Goldman Sachs) and 1.3% (International Monetary Fund) in 2008. Current economic activity varies among sectors; construction and housing remains very depressed, while exports continue to boom due to favorable exchange rates.

However, even if most of the existing projections are incorrect and GDP dips into recessionary territory, it appears any potential economic downturn will not be as severe as is presently perceived by most consumers, businesses and investors.

This gloomy perception of the economy is reflected in declining consumer sentiment data and other similar statistics. Yet, it is

important to note that both recessions and expansions are normal elements of economic cycles and remain an inherent part of the world's economic and investment landscape. Certainly, some concern is warranted when recessions might appear, but not undue anxiety.



Throughout the course of the year, US employment has been softening and has contributed to depressed consumer sentiment. However, this issue should be examined in terms of its factual reality, rather than the popular perception. As shown below in Exhibit 2, the current 5.5% unemployment level which continues to tick up, remains below its historical average and is well below the levels reached during previous recessions. Further, as seen in Exhibit 3, current average job losses are substantially below the levels reached during the 2001 - 2002 recession.

Exhibit 2

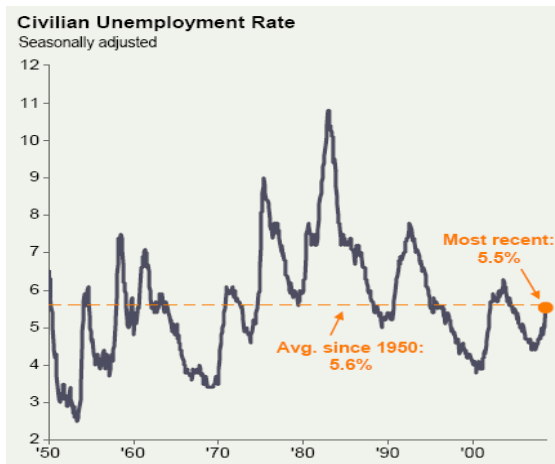
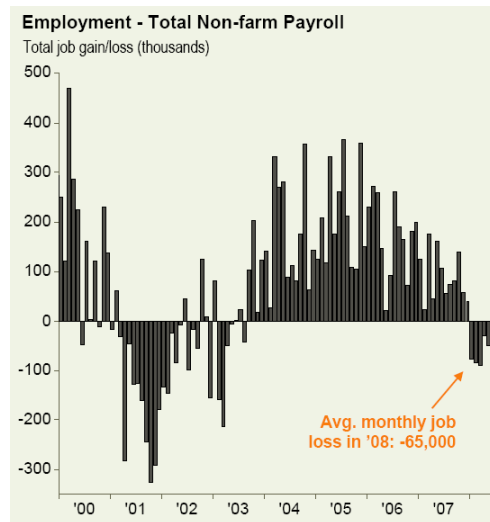


Exhibit 3



3Q08 Guide to the Markets, JPMorgan Asset Management, page 17

Exhibit 4 below presents interesting historical information prepared by JPMorgan Asset Management on the Consumer Sentiment Index and the S&P 500 Index 12-month return subsequent to the date the Consumer Sentiment Index hit its low point for each

of the identifiable periods over the past 38 years. Exhibit 5 shows Unemployment Spikes (equal or greater than 0.5%) and the S&P 500 Index 12-month return subsequent to the month the Unemployment Index spiked the highest during the last 59 years. Please note the historical information presented below is not, in any manner, an indication that future market behavior will be repeated.

Exhibit 4

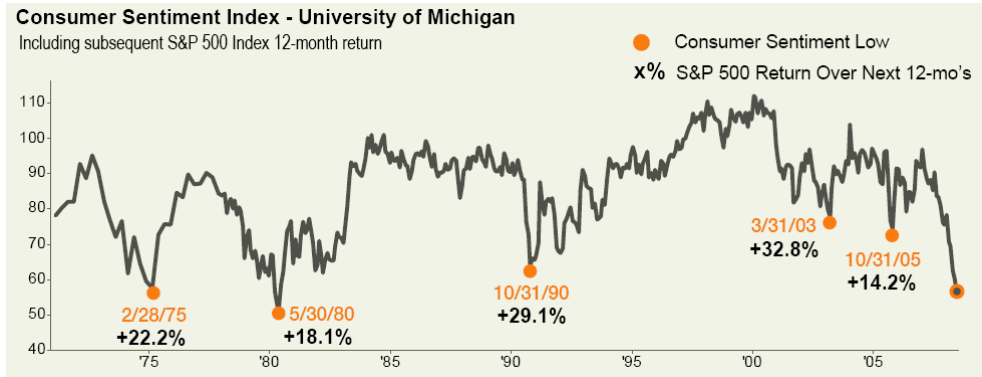


Exhibit 4 was taken from the 3Q08 *Guide to the Markets*, JPMorgan Asset Management, page 22. Source: Standard & Poor's, BLS, FactSet, University of Michigan, JPMorgan Asset Management. Market returns reflects S&P 500 index return (not including dividends) for 12-month period following each low in consumer sentiment as indicated in chart. This chart does not imply that June 2008 is a new low in consumer sentiment.

Exhibit 5

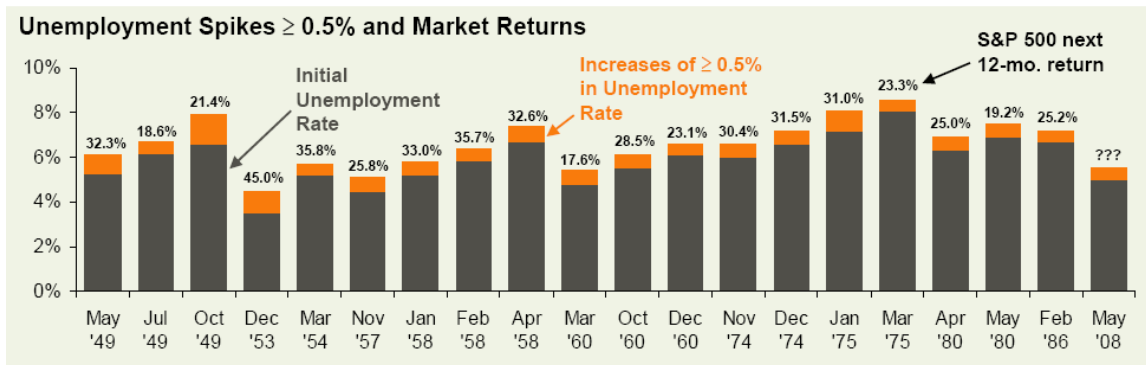


Exhibit 5 was taken from the 3Q08 *Guide to the Markets*, JPMorgan Asset Management, page 22. Please note the vertical axis represents the Unemployment Rate. Source: Standard & Poor's, BLS, FactSet, University of Michigan, JPMorgan Asset Management. Market returns reflects S&P 500 index return (not including dividends) for 12-month period following each unemployment spike as indicated in chart.

However, after reflecting on the level of negativity in the Consumer Sentiment Index, questions arose. If the health of the US economy is delicate, but not dire, why is the Index currently so low? Where is the disconnection between dwindling sentiment and economic reality? Some of the answers to this quagmire lie in the fact that while...

- 94.5% of the labor force is employed;
- Average hourly earnings still are increasing at a rate above the 20-year historic average;
- Gains in labor productivity remain high (recently 3.3%); and,
- After-tax corporate profits (as a percent of GDP) still are well above their historical 6.0% average

other distressing aspects of daily life void the impact of the above positive economic indicators and taint perception of the economy. For example, consumers feel powerless, are angry and experience real pain when...

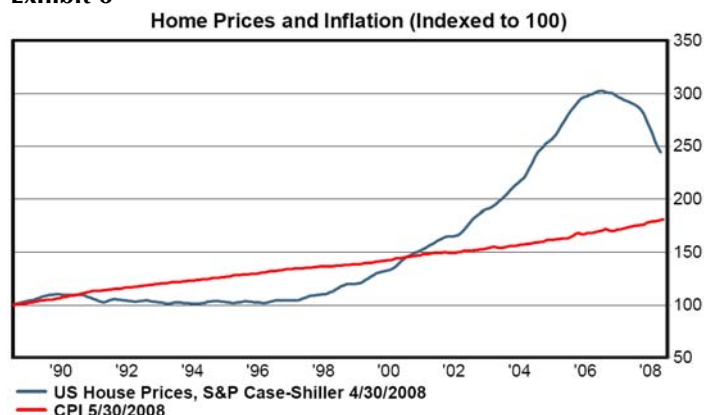
- During their weekly (or more frequent) visits to the gas station, they constantly pay increasingly higher prices for gas, now exceeding \$4.00/gallon.
- Similarly, food prices are escalating significantly. Although energy and food prices have increased dramatically and have caused traumatic experiences in many households, prices excluding these commodities (e.g., core CPI) generally appear to be under control and in many cases are declining due to the softening economy.
- The constant barrage of news proclaiming the devaluation of home prices further dampens homeowners' psychological well-being, even when homes purchased prior to 2004 (i.e., representing the majority of homeowners) have in most cases appreciated versus their original cost.
- Individuals' monthly brokerage and retirement statements (where applicable) show market values still declining, further exacerbating the impact of the above upsetting daily occurrences.

At the end of the day one can conclude that the economy is indeed soft and tangible issues exist that are affecting the country; yet, this is a situation where perception is more pessimistic than reality. The real potential problem of significant concern is that often negative perception can and does affect consumer and business behavior in such a way that the perception itself becomes a self-fulfilling prophecy.

Since late 2006, the main culprit of the country's economic and financial dislocation has been the bursting of the residential real estate bubble. One of the consequences of this dramatic event has been a nationwide decline in home prices, with more pronounced drops in certain geographic markets (e.g., Florida, Nevada, and California). Exhibit 6 below shows the S&P Case-Shiller US House Prices Index during the last 20 years. It is worthwhile to note that from 1990 to 2000 home prices did not keep pace with inflation (as measured by the CPI), but from 2001 through 2006 home prices increased over 100%. Most of this increase can be attributed to real estate market excesses; however, some of the increase can be reasonably considered to represent a "catch-up" to the inflation gap experienced during the 1990s.

After considering the recent doubling of residential real estate prices, one should not be surprised to witness, on average, a 15-20% (or more) decline in current home prices. It is important to recognize that the value of the average home purchased prior to 2004 is still seeing a relative price appreciation. The most problematic price devaluations

Exhibit 6



represent residential purchases made during 2004 through 2007.

Crude Oil

Another factor that has affected the world economy has been the increasing price of oil. From March-June, oil has risen 38% to \$140/barrel marking the best quarterly performance for the commodity since the first quarter of 1999. Since the end of the second quarter, oil has increased again to a record price of \$147/barrel, yet subsequently has declined to approximately \$124/barrel, as of the date of publication -- July 25th. While no one can know where oil prices are heading, it is clear current prices already are having a significant impact on the global economy. Nevertheless, it is important to recognize that rising crude prices (as well as other commodities) are more likely to hamper growth than boost inflation. In discussions on this issue, three major factors contribute to the price rally; however, there is much debate on the weight and importance of each factor:

- fundamental supply and demand conditions;
- a weak US dollar; and,
- speculation by investors.

There is no question that substantial economic growth in developing countries, and the likely continuance into the future, has changed the supply/demand equation for oil in the world economy. Oil prices under \$50/barrel are a thing of the past. Prices in the distant future could reach extremely high levels assuming no new alternatives are found and existing substitutes (e.g., natural gas, wind, nuclear, solar, tar and shale oil, etc.) are not aggressively implemented. The current debate on the price of oil during the near future centers on whether the price will be \$150 to \$200/ barrel (or even higher), or retreat to under \$100.

At current price levels, demand in developed economies (e.g., the US) has started to decline. Demand growth in developing countries (e.g., China) has been maintained, in part, through heavy subsidies far below the current market price. As these fiscal subsidies take their toll on government budgets, often at the expense of social and economic programs, some price increases might result, potentially reducing demand. At the same time, there are many potential sources of increased supply that have stagnated due to under-investment, political restrictions and government inefficiencies. Reversals of some of these conditions might, at the margin, increase supply. The combination of both factors certainly could reduce prices; however, the extent of this decline is unknown.

A weakening of the dollar absolutely has contributed to the increase in oil prices, but at some point in time this trend might reverse, especially in relation to the euro. In terms of speculation, the real issue is not the trading done by traditional speculators, who are very active in the market, but the actions of a new breed of institutional financial investors (e.g., pension funds, university endowments, foundations, sovereign wealth funds, etc.).

These institutional investors had limited participation in the commodity futures market prior to the equity bear market of 2000-2002. However, the severity of this event led

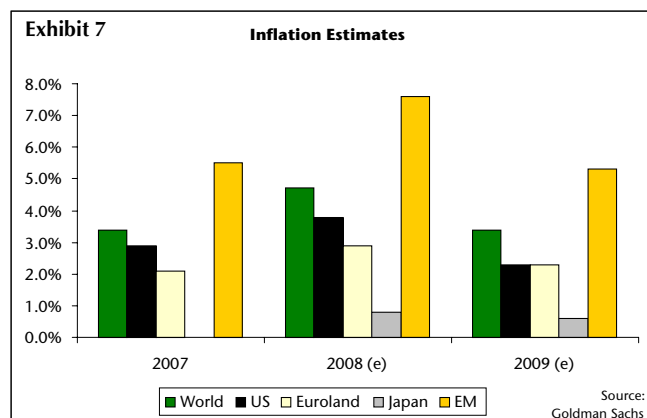
such investors to more actively participate in this asset class making it an integral part of their portfolio investment policies. Unlike traditional speculators, who trade commodity contracts at high turnover rates, institutional investors basically “roll-over” their positions making these vehicles long-term investments.

Data compiled by Michael Masters, a hedge fund manager, and presented to a Congressional Subcommittee this past May shows that assets allocated to commodity index trading strategies have risen from \$13 billion at the end of 2003 to \$260 billion as of March 2008. The significant increase in activity by these “new long-term investors,” as well as higher allocations to this asset class by the growing universe of hedge funds, must have had an impact on the price of oil. Whether significant or not, the impact is still not known.

Current studies on oil market speculation, undertaken by the Commodities Futures Trading Commission, have led the CFTC to tentatively conclude that the impact of traditional speculators was not substantial. However, a study on the “new” institutional participants is ongoing. Results of this study may not be available until 2009, due to insufficient data.

Inflation

Inflation concerns have affected consumer confidence. Led by commodity prices, global inflation has been increasing in 2008, although lower economic growth is expected to help moderate inflation growth in 2009. (See Exhibit 7). While headline CPI statistics in the US have been edging higher, the core CPI has been more stable. This means that higher commodity prices have not yet started to trickle into the rest of the economy. The Federal Reserve is concerned about this issue and most likely will start to tighten monetary policy as soon as improvements in economic conditions permit. However, it appears the Fed’s immediate priority is the re-establishment of stability in the financial system, as well as growth in the economy.



The Fed has been extremely active in addressing issues affecting the stability of the financial system and has implemented, in many cases, extraordinary measures to re-establish confidence in the financial markets. Some of these measures have been criticized as inflationary. Some critics have gone as far as saying that the country is facing the risk of an inflationary spiral similar to the one experienced during the late 1960s and 1970s.

However, given the overall reduction of liquidity in the credit markets, the Fed’s actions appear not to be inflationary. Concerns that a combination of an accommodative monetary policy and escalating commodity prices will lead to a spiraling inflationary economy has not yet been realized. In fact, although skyrocketing commodities have

caused some to reminisce about the inflationary outlook of the 1970's, the US economy today has little in common with that time period.

Exhibit 8, originally presented in Western Asset Management's June 2008 publication, *Is it Inflation?*, shows how the two time periods differ substantially.

| Exhibit 8 | | |
|--|--|--------------------------|
| Contrasts Between 1960s/70s & Now | | |
| Indicator | Late-1960s | Present |
| Core CPI | Accelerating, 6% | Stable, 2.5% |
| Retail Prices | Rising everywhere | Falling at most stores |
| Unit Labor Costs | Accelerating, 8% | Decelerating, 0% |
| 10-Year GDP Growth | 4.4%, 2 nd fastest in history | 2.3%, slowest in history |
| Spending Growth | Accelerating | Stable/Slowing |
| Home Prices | Rising | Plunging |

Source: Bureau of Labor Statistics, Bureau of Economic Analysis, National Association of Realtors, Western Asset.

Is it Inflation?, Western Asset, June 2008, page 6.

The authors conclude: (1) current conditions are quite different from those of the 1960s/1970s, (2) the present high level of concern is not warranted, and (3) US inflationary pressures will subside given present economic conditions.

In fact, unlike today, the energy shocks of 1973 and 1979 occurred during a time period that was already experiencing inflationary pressures in other parts of the economy. Today, oil and food shocks are transpiring during a setting of stable or falling prices.

Other World Economies

The Eurozone also has experienced an economic deceleration as higher commodity prices and currency appreciation have added to the effects of the global slowdown. Tighter monetary policy already has, and is expected to continue to impact GDP growth rates. Inflation is more likely to trickle into the real economy here as approximately 50% of Eurozone wages are partially or fully indexed to past inflation; this could lead to an automatic second-round inflation effect.

Japan's growth outlook also looks softer for 2008. Domestic demand has been supported by accommodative monetary policy. Consumption has been relatively strong. However, exports have been more muted despite relatively strong Asian demand.

The prospects for economic growth in emerging markets continue to be positive, albeit at slowing rates. Emerging market inflation is becoming problematic and will need to be addressed with aggressive monetary and fiscal policies (as has already been done in some countries). This in turn will reinforce the trend towards lower GDP growth.

In summary, current and future global economic activity is trending toward lower (yet still positive) growth rates, including in the US.

Year-to-Date Market Performance Summary

Exhibit 9 shows year-to-date returns for major equity and fixed income indices.

| Exhibit 9 | |
|--|----------|
| Year-to-Date Total Returns* | |
| 12/31/07 – 06/30/08 | |
| <i>Major Equity Indices</i> | % |
| S&P 500 Index | -11.9 |
| Russell 3000 Index (Total US market) | -11.0 |
| Russell 2000 Index | -9.4 |
| MSCI EAFE International Index (Net) | -11.0 |
| MSCI All Country Ex-US Index (Net) | -10.2 |
| <i>Major Fixed Income Indices</i> | % |
| Lehman Brothers US Aggregate Bond Index | 1.1 |
| Merrill Lynch US High Yield BB-B Bond Index | -0.8 |
| JP Morgan Non-US Index Hedged | -0.3 |
| JP Morgan EMBI Global Index (Emerging markets) | -0.2 |

* Including price appreciation plus dividends and/or interest.

Equities

Stocks continued their decline during the second quarter as rising crude oil prices, massive write-downs by large Wall Street banks, fears of a slowing global economy and rising inflation drove equity investors to the sidelines. Most of the downward pressure in the market came from the financial sector, while gains in energy stocks offset some of this decline. The broader market saw growth stocks significantly outpace value, while smaller capitalization stocks out-performed large caps.

While international equity markets fared somewhat worse than US stocks in local currency terms, their returns in US dollars were somewhat better due to the appreciation of foreign currencies relative to the dollar. Emerging market returns in US dollars approximated the declines seen in the US and in other international developed countries.

Uncertainty and fear in the markets almost always create opportunities for long-term, patient investors. We believe such opportunities now exist in large US and international equities and in both value and growth companies. Where appropriate, we will gradually rebalance portfolios in order to take advantage of some of these opportunities. On a more selective basis, we also might find opportunities in other areas such as real estate and mid-caps.

Fixed Income

During the first two months of the second quarter, government bond yields rose, essentially reversing the flight-to-quality seen during the first quarter. By the end of the first quarter, investors seemed more comfortable with riskier levels of debt after the Fed acted to provide liquidity for broker-dealers.

During the second quarter, credit spreads narrowed as corporates and agency mortgage-backed securities rose. However, starting at the end of May and carrying through June, inflation fears amid high commodity prices led investors to worry about potential Fed action to raise interest rates. Additionally, credit agencies lowered their ratings on two bond insurers, MBIA and Ambac Financial, that guarantee \$1 trillion in debt, affecting the pricing of their insured securities. The combination of these effects resulted in a 1.0% decline in the broad bond market reducing the year-to-date total return of the Lehman Aggregate Bond Index to 1.1%.

In the short-term, inflation fears and stresses in the financial system may continue to weigh on the fixed income markets. However, opportunities exist in the mortgage and corporate sectors and on a more selected basis, in other areas of the fixed income arena. The exception would be in Treasuries, which we believe are presently fully valued.

Sincerely,

The SOL Capital Management Team