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Spring Commentary 2007

The Markets & The Economy

The first quarter of 2007 was a rollercoaster ride in the truest sense. Following a 3.3% decline in one day, February 27, the world's stock markets rebounded and the quarter ended basically flat. The prognosis for the next few quarters is only slightly better, as we are looking at an increasingly severe housing downturn, slowing corporate earnings, and steadily rising energy prices. All in all, the Federal Reserve has little justification for cutting interest rates other than to try to keep housing prices from further erosion and to bolster consumer sentiment.

During the first quarter, the Dow Jones Industrial Average declined <.31%> with dividend while the small stock index, The Russell 2000 Index, gained 1.9% with dividend. The Standard & Poor's 500 Index gained .64% with dividend and the technology laden NASDAQ 100 was up .44% with dividend. The Rikoon Carret U.S. large cap stock portfolios gained 2.17% during the first three months of the year.

In the international area, the Dow Jones Global Stock Index, which measures the performance of major European companies, gained 2.5% during the first three months, while Japan's blue chip index moved ahead .4%. It is important for investors to realize that most of the world's stock markets tend to rise and fall together now as the flow of capital around the world becomes easier for investors at all levels. Germany was the best performing industrialized country with a gain of 6.7%, while the United Kingdom, regarded as a growing magnet for financial service industries, rose 2.1%.

Conversely, hot stock markets like China, India, and Vietnam are beginning to be seen as quite expensive, and they declined around 4%. The developed nations in Europe and Japan are looking better to us for the long term, as they have sustainable expansions underway, especially Japan.

Rikoon Carret's international stock portfolios rose 3.65% during the first quarter. We continue to emphasize international investing for our growth portfolios. We have lately reduced positions in most emerging markets but continue to look to Eastern Europe as a bright spot.

The U. S. dollar fell slightly over the past three months, while oil prices rose about 7%. Gold rose 4.4% and the demand for industrial commodities was robust. Since the lag time is so long between immediate market demand and any increase in supply, many global commodities investors have moved into metals such as nickel, aluminum and coal.

In our portfolios, we have identified a basket of stocks in the agricultural sector and are beginning to look towards some long term investment in that area.

The bond markets have had the jitters so far this year. Sectors such as mortgages and corporate junk bonds had their frightful days, but with an unchanged Federal short term interest rate of 5.25%, many investors are still chasing high returns in the bond arena, and this has provided some stability to these markets. The U.S. taxable bond market rose 1.54% during the first quarter of 2007, and the Rikoon Carret taxable bond portfolios rose 1.52%. Tax adverse investors continue to have fairly low returns, as the short term municipal bond index gained .89% and the Rikoon Carret portfolios gained 1.02% during the first quarter.

Frequently I am asked, "What is going on out there in the financial world?" The headlines are full of news regarding private equity firms such as Blackstone Group, Apollo Management and Kohlberg Kravis who are bringing multi-billion dollar deals into the market. We are seeing a new phase in financial service mania. Wall Street investment bankers made 1.1 trillion dollars of deals and collected 2 billion dollars of fees during the first quarter of 2007, far outstripping the record period in 2006. U.S. private equity firms have taken companies such as Texas Utilities, Hertz Car Rental, Dollar General, and soon First Data Corp., from public ownership to private. Investment banks and their Wall Street law firms are trying to get as many deals done as possible before an inevitable slow down in this buying and selling mania. Daimler Chrysler is expected to sell off its Chrysler division to these private equity firms who refer to themselves as "financial sponsors."

Who are private equity firms? Like hedge funds, they are unregulated companies who band together investors such as pension funds and wealthy individuals with the hope of leveraging their contacts and access to cheap money into double digit returns, no matter what direction the overall stock or bond markets take or how the companies they take over fare.

These firms are involved in about one-fifth of all deals done worldwide. Their ability to take control of companies depends on massive liquidity and cheap financing, as they borrow up to three-quarters of the amount used to take public companies private for resale.

Shareholders of public companies who are frustrated with the returns of their stock often pressure management to sell to these private dealers. There is too much money chasing too few deals, and my fear is that the public and their pension funds will end up with pennies on the dollar.

In the "real" world, the U.S. economy has been lackluster. Business investment in equipment and software registered its largest drop since 2002, excluding aircraft and military defense orders. The Federal Reserve does not really understand why businesses, flush with cash from years of record profits, are not using their money to expand. Rather, much of this corporate liquidity is going towards buying back its own stock. Why?

Public companies with low stock prices are vulnerable to these private equity firms who break them up, take home the largest portion of the profits, and then leave them to struggle with debts.

It's similar to the unfolding housing finance debacle in that the largest financial institutions set up a huge nationwide firm to create a market in "sub-prime" loans. These are mortgage loans to people with poor credit ratings or high amounts of debt. The financial service industry has packaged mortgages, auto loans, aircraft leases and credit card receivables in order to sell them to yield hungry investors. The housing market boom of the early 21st century will be seen, in retrospect, as having been fueled by the liquidity created by financiers who were enabled by the government's effort to stave off an overdue recession.

Some parts of the overall economy, employment and basic wages, have remained surprisingly strong. Inflation has stayed above the level that the Federal Reserve would like to see so it is very difficult for the Fed to reduce interest rates as most people expected earlier this year. Looking ahead, we see good, but not great, earnings reports for corporations and probably the slowest growth in corporate profitability in three years. It will be difficult for stock prices to rise sharply given these steady but unexciting results.

The stock market's decline in late February reminds all of us of the pitfalls in the markets, especially when profits are generated by reshuffling and reselling things, rather than by actual production. If the finance sector has a huge hiccup, stand well back. Our belief is that the large U.S. companies stand to provide the most stability in the turbulent financial times we see ahead. Capital spending, ie. actual investment in future plant and equipment by the S & P 500's industrial companies, was up 20% earlier this year as compared with a contraction in the purchase of capital goods by businesses in general. We feel the S & P 500 companies, or a particular subset of them, stand to provide consistent returns over the next several years.

Rob's Texas Run

On Friday, February 1, I flew from Asheville, NC to Houston, TX on a cold and windy day to meet up with two men in their early 60's, both of Jewish descent, an industrial truck salesman from New Jersey and a urologist from Brooklyn, one of whom was going to run in a race called the "Rocky Raccoon 100 Mile Challenge".

Hanging out with these two fellows the day before the race was like being in a tree house with a bunch of 13 year olds. Notwithstanding their non-stop chatter, we retired around 9 o'clock; three of us packed in a small motel room. I rose at 3 a.m. to get ready for the start at 6 a.m. We were in Huntsville, TX, an hour north of Houston.

The weather was well below freezing, but figuring we were in the south, I put on running shorts, which turned out to be the wrong decision as my leg muscles eventually swelled up due to the cold. About 375 runners moved out in the dark, with one-third planning to

go 50 miles and the rest of us aiming for the full 100. The course was five loops of twenty miles through pine forest, swamps, mud holes, and bridle paths. What fun!

Texas hospitality abounded as there were food/water stops every 5 miles. Traveling on airplanes 16 days per month for the six previous months was not great lead up or preparation for the race. I had experienced a slight muscle pull deep in my left hip the week before the race because I had gone direct from the airport to do a trail run in lousy weather. The injury was bothersome during the first couple of hours and then all sensation of it went away as other pain arose.

As the sun came up over the central Texas swamps, I spent the first 8 hours enjoying the race environment and fairly benign trails compared to the rocky terrain of New Mexico's mountains or the gnarly root of the Southern Appalachians. In addition, I didn't have to talk too much thanks to my companion, the Jewish doctor, who seemed to know everyone on the course. He is an awesome runner but I just churned away, trying not to overdo it. We walked most of the up hills for the first 60 miles, since my buddy's sage advice was to save some juice for the upcoming night time portion of the event.

As darkness fell, so did the temperature and my spirits. During the course of the day, I had developed a fairly painful bruise on my calf. The backs of my knees, where the hamstrings turn into tendons, had turned black and blue and begun to swell. At mile 60, I seriously considered stopping. Because of a promise I had made to family and friends that I would be sensible, I told my running companion that I was considering quitting. He looked at me like I was crazy.

I had come to the point when I could no longer run and only by force of will could I walk. At 8 p.m., I looked around at the makeshift camp with its bonfires that volunteers had lit for the 50 milers and 100 miler dropouts. The thought of waiting around in sweaty clothes for fourteen hours helped me decide to start out on Loop #4. However bad my legs were feeling, it wasn't so bad that I couldn't go any further and I wasn't overly tired either.

Leaving the aid station, I figured it would take me about 7 hours to go 20 miles in the pitch black. There was a full moon and I was looking forward to some alone time. Also, however weird it sounds, the pain of stopping my forward motion was worse than of going on slowly so that is what I did, inexorably putting one foot in front of the other.

Because of the pain, I was no longer able to enjoy the scenery. Though I wasn't running, I steadily advanced. I had encouraged my running partner to leave me behind so he could go ahead at his own pace with new companions who he picked up along the way. At the 80 mile mark, I came into the aid station only a couple of minutes behind him, amazing both of us, because he had run most of that loop. It just goes to show that slow and steady is often the most efficacious approach to winning one's personal race!

We are, by and large, social creatures. Even long distance runners like company. Companionship is especially important in the middle of the night. I was missing my

pacers from the Leadville 100 mile race last August. One of the reasons I did this race in Texas was to see what it would be like to not have a crew. As the race wore on, I missed them more and more. Though I was experienced in knowing what to eat and drink, I was not eating enough. I knew this as a fact but could not bring myself to eat more. A pacer would have forced me to eat, but I was running alone, shuffling really, and did not have the presence of mind to do what needed to be done.

My energy was low but constant. I felt like I was underwater. At the 80 mile mark, it was 2 a.m. Again, I caught up with my friend. Should I go for the last 20? My legs were in such a state that I decided not to look at them or consider the consequences of further effort. “What the heck” I thought, and in the middle of a cold wind, headed out for the last loop. As I plodded along, I debated in my mind whether this kind of activity was healthy for the mind, body, and spirit. I was unable to reach any conclusions or even pass judgment.

All I was able to do was to keep moving and stay focused on not losing the trail. My buddy’s new running mate was now hobbling along and at mile 88, I passed her. His contagious, encouraging chatter and good spirits enabled him to move ahead and he finished in good form. As daylight broke, I was two-thirds around the final loop, advancing quite slowly. The last several miles, a few older guys passed me. They were somehow still able to run and it gives one pause for thought that this sport is much more mental than physical because there is no way those guys were in better physical shape, they were just flat out in better psychological condition .

At twenty-seven hours and forty-two minutes, I came back into the campgrounds, making my way to the finish line. I crossed over it in a state of disbelief. People congratulated me, but I could not hear their words because I began to weep, silently. I knew no one at the finish line, but for some strange reason, I wanted to be alone, even though I had just run by myself through the darkness for 14 hours.

The majority of runners who had finished were milling about having a good time with their friends and families. I knew that when I stopped moving, the piper would have to be paid for overdoing it and sure enough, I immediately got chilled and dizzy. During the second half of the race, every time I would stop at an aid station, my leg muscles would tighten up. Once my body started to feel itself, it was bound to be extremely painful and it was. My two friends helped me into the car and back to a motel room that another runner had lent us to shower.

“No rest for the wicked” is one of my favorite expressions. After a quick “meal” at the local Sonic, we headed towards the airport. I hobbled through security and onto an airplane to return to New Mexico. Everything worked out well as I got upgraded to first class where I was able to elevate my feet. Though I was not feeling chipper, my fellow passengers were tolerant of my glacial pace as I shuffled off the plane late that evening.

The drive from Albuquerque’s airport to Santa Fe that night was probably the most dangerous I had ever taken since I had not slept the night before and my legs were pretty

useless. I recovered slowly with some anxiety about the swelling and pain that continued for three weeks after the race. I had pretty much decided that doing any more 100 mile trail runs might not be in the cards. Why would someone run/walk 100 miles non-stop in the first place? To this excellent and rational question, I have no good answer except to say that we do what we must, and on most days, we hopefully enjoy it. Now that enough time has passed, I can say that I did enjoy the Rocky Raccoon. Will I do it again? Probably not but one never knows!

Personnel News

Juliana: If you are looking for a great getaway, I can highly recommend Canyon Ranch in Tucson. In mid February, my mother and I spent 5 days there, each one filled with great exercise classes, healthy tasty meals and of course relaxing body treatments. Needless to say I would have been happy to stay a few days longer.

Jeff: My daughter, Stephanie, and I enjoyed this past ski season. She was able to successfully switch to snowboarding from skis this year. I tried snowboarding one day and did okay, but I still went back to the ease and familiarity of my skis afterwards. I will try snowboarding again next season. My wife and I are looking forward to undertaking more gardening and landscaping projects this summer.

Patricia: I will be cheering on my son from home. Dylan will be doing a bike ride from London to Paris just prior to the Tour De France. He will arrive back in London for the start of the Tour De France. I plan to turn my attention to landscaping, vegetable gardening and house painting this summer.

Dana: I recently enjoyed a spring trip to Maui. The highlight was kayaking among whales, a pod of spinner dolphins and one very large, lumbering sea turtle. It was reassuring to find the earth is still alive!

Upcoming Events

The next tea will be held on Thursday, May 17, at an offsite location and at two different times. In February, we experienced a good response to using the conference room at the Inn on the Alameda, and we held a gathering both at 3 p.m. and again at 6:30 p.m. So once again, we will hold the tea at the Inn (303 East Alameda Street) at the times above. Please let us know in advance if you think you will be able to attend either session. Of course, you're invited to bring friends and family.