Rochdale
Investment Insight

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2007 Mid-Year Market and Economic Outlook

A conversation with Garrett R. D'Alessandro, CFA, AIF®
Chief Executive Officer, President, and Director of Research

Highlights:

- In looking at the consumer, we are concerned that housing is very weak, but we see enough other positives that outweigh the housing concern. Job growth and wages will support consumer spending at a sub-optimal level of 2% to 3%, compared to normal spending of 3% to 3.5%. Consumers are in a self-sustaining level of spending about which we are confident.
- Looking beyond 2007, the economy should work through its current housing challenges, and move towards a 2.5% to 3% overall GDP growth trajectory.
- We estimate oil in the $60 to $70 price range. It is currently above that, and our belief is there's between a $5 and $7 agitation premium.
- We expect reasonable productivity growth and intense global competition to keep inflation in check this year. Despite the fact that we have rises in gasoline, energy, and corn prices, we see that core inflation also is subdued and is now at about 2%.
- We forecast that the Fed is on hold for the rest of the year, but we have increased the chance they may cut rates if credit markets continue to tighten.
- The manufacturing/industrial side has picked up over the last few quarters, and we see a fairly pronounced and persistent upturn in our leading manufacturing index. Industrial growth is likely to resume an upward trend in the next few quarters.

The following discussion is moderated by Kashif S. Ahmad, CFA, Vice President, Investment Consulting, of Rochdale Investment Management.

Q: Garrett, let's start by taking a look backwards. Please provide us with a summary of how the economy has performed thus far in 2007.

A: The first half of 2007 has been a tale of two segments. When we break the economy into two pieces, one being services and the other being goods and manufacturing, we see positive trends in both sectors. We give the services sector a solid B+ for the first half of the year. Additionally, the goods and manufacturing segment has had three consecutive months of rising manufacturing activity, which bodes well for the second half of 2007.

The residential housing sector continues to grab the majority of the headlines, as the housing recession remains. With the exception of the housing and energy sectors, all other components of the economy generally have been trending positive as we approached the mid-point of 2007. In particular, job creation has been good, wages have been good, and corporate profits have exceeded expectations. While consumer spending was weak, it has shown resiliency, which can be attributed to the healthy job market.

Two unexpected positives from the first half of the year have been the reduction in the U.S. domestic trade deficit and the export growth of our economy. Both have contributed to GDP growth in the first half of 2007.

Q: In looking ahead to the rest of 2007 and even into 2008, what would you consider to be the biggest surprises and the most positive highlights?

A: We think about several things when we look at the economy. We think about what the big pieces of the economy are, and the biggest piece remains obviously the consumer. What drives the consumer is employment growth, new job creation, and wage gains. That is among one of the most critical aspects that we're focused on for the second half of 2007, and all indications show that payroll growth and wages will remain consistent during the second half of 2007.

The second major aspect that we look at relates to corporations. In terms of corporations, we like to consider the following: profitability growth; strength of the balance sheet, which is what we call the sentiment of the CEOs to expand their plant and equipment; ability to build and buy new capital technology equipment; and hiring. All of the aforementioned sentiments that we look at are positive. We're looking at the second half of 2007 and giving it a slightly better grade than the first half of 2007. While housing still is not going to be a positive as we exit 2007, the substantial drag that occurred in the first half is going to mitigate somewhat. We'll still have a negative, but it will be probably half of the negative we have seen so far in 2007. With corporate profits still doing well and consumers still doing okay, we're forecasting, as I like to call it, smooth glide sailing for the second half of 2007. We see very few storms on the horizon for the overall economy.

Q: Sometimes it's better to start with the conclusion, so you can better understand how the conclusion came about. How would you grade the overall economy, looking ahead?

A: Looking ahead to the next 6 to 12 months, we're giving the economy a B-.

Q: What are the principal components that lead to the B- for the economy?

A: I read a lot about this notion called a soft landing, and on my flight yesterday, the landing was anything but soft. But the landing, nevertheless, actually makes you come down to the ground, and I'd like to characterize the economy as gliding along at about 20,000-25,000 feet. We're on a sustainable glide path, and I want to reinforce this notion.

The self-sustaining nature of economic activity in the consumer and the corporate areas of the economy looks solid. So when you take a component of the economy, such as housing, which is just one segment of a multidimensional economy, it's not going to cause all the dominoes to fall down. When we look at the consumer, we are concerned that housing is not great, but we see many other positives that outweigh the housing concern. The numbers that I spoke about before in terms of job growth and wages will lead the consumer to perform at a sub-optimal level. They normally spend 3% to 3.5%; perhaps they will spend 2.5%, but that's a self-sustaining level of spending about which we are confident.

The next area that we look at relates to what our economy essentially has become: a services economy. About 70% of our economy now is services, and that segment of our economy is doing very well. We see this success carrying over into the second half of 2007.

The goods side, the manufacturing or industrial side, has picked up, as I said, over the last few quarters, and we see a fairly pronounced and persistent upturn in the leading manufacturing index. That, along with recent rises in the Institute for

Supply Management (ISM) and orders data, leads us to believe that the industrial growth is likely to resume an upward trend in the next one or two quarters. That will add to the strength in the services sector, and that is why we're saying 2.5%, maybe 2.75%, GDP growth for the second and third quarter of 2007, and we see early signs that that will continue into 2008 as well.

Q: You pointed out some strengths in the economy and factors leading to strong growth for the rest of 2007 and 2008. What aspects or circumstances are you most concerned about that may not go as expected, or what surprises could you see that may cause you to change your economic forecast?

A: We look at the leading indicators of the economy, and those leading indicators are what will guide our outlook beyond 2007. But I want to reiterate that the important component that we're focused on is employment. The consumer will do fine as long as wage growth and new job creation continues. Something that would give us concern would be corporate executive sentiment starting to turn less positive, which would be an early warning indicator that maybe employment growth will not continue as strongly as we expect. We don't see that happening now, but you asked what would be a surprise perhaps or what a shock would be.

Another surprise or shock that we don't expect, but we're on the lookout for, would be something we call a financial market contagion. The Japanese carry trade, the heightened level of speculation in the local Chinese stock market, and the weakening of the U.S. dollar are all financial market components that might surprise us or would alter our view if drastic changes took place. Also, oil must always be kept in mind if the price becomes substantially higher than it is right now.

I would characterize all of those potential surprises or shocks as small in probability individually, and generally unlikely. If any of them were to occur individually, they would struggle to overpower the positive components that I've alluded to before about the self-sustaining, reinforcing nature of the economic expansion that's in place. If the economy has 15 dominoes in a strong, positive position, the falling of one domino will not result in the tumbling of the others. Economically, this is exactly where we are right now.

On the business side of the economy, we're not very sensitive regarding corporate profits. Some sub-prime losses, a little bit of housing weakness, or even an $80 oil price are not going to materially influence our view on corporate profitability. But if several of these surprises were to occur simultaneously, we might feel differently.

Q: Everything that has been discussed so far has been geared towards the positive, so let's start looking at the negatives as well. What about the risk of recession? Thanks to the media such as CNBC and the Wall Street Journal, we hear daily about problems that might occur. We have difficulty trying to separate what is noise from what the real issues are that we should really be concerned with.

A: Recessions occur when a series of events happen that are reasonably well identified, and that series of events is not in place at the moment. To review, we have strong corporate balance sheets, strong corporate profits, strong employment growth, reasonable liquidity, global expansion, growing exports, and we have basically balanced monetary policy. Those factors allow us to withstand one shock or a small hit from other things. So we put the risk of a recession for the rest of this year at 25%.

Q: What about the consumer? There is a lot of discussion about how we all, as consumers, have seen our debt rise. What are your thoughts on consumer income and consumption in 2007?

A: This might be somewhat provocative, but we think actually that the consumer's balance sheet is in pretty good shape. And what do I mean by the consumer's balance sheet? The net worth of individuals in aggregate has risen to a level that is unprecedented in American financial history. Net worth is the value of the assets minus the value of the liabilities.

While it is true that people have taken on some home equity debt or additional mortgage debt or borrowed for cars, they have an asset level that has grown more than their increase in liability. So, the balance sheet looks reasonably healthy for most consumers. The growth rate of income above the rate of inflation is another good sign.

The negative, as we know, relates to housing. Most of the net worth in housing is still positive; it is just less of a positive, because the gain that they previously had that was on paper, or unrealized, is less than it was a year ago.

A few additional points about the consumer: While short-term debt is important, it's at a very manageable 32% in relation to disposable personal income. What that means is that, if they were so inclined, with three or four months worth of their total income, the consumer could pay off all their short-term debt.

Another helpful statistic is solid consumer liquidity, with liquid assets at 47% relative to disposable income. Consumers' short-term assets – cash, money market, near-term investments – represent about 47% of their annual income level, which provides them with reasonable access to funds.

On the mortgage side, it is correct that we are at a record level with roughly 73% of household debt in mortgages, and that can be attributed to, as we know, the housing boom.

Q: What is Rochdale's outlook for inflation for the rest of 2007?

A: Here's some good news. Our leading indicators of inflation have fallen to the lowest level in about two years. That means that our forward expectations for inflation are in a cyclical downswing. Despite the fact that we have rises in gasoline and energy and corn prices, we see that core inflation also is subdued. Core inflation is now down to about a 2% annualized rate, which is within the zone with which the Federal Reserve Bank has expressed some level of comfort.

We expect reasonable productivity growth and intense global competition to keep inflation in check this year. On a longer-term basis, with the high capacity utilization of the employment situation, we do expect the Fed not to cut interest rates this year, despite many other people claiming or calling for a cut to offset the housing weakness. We see enough sustainable growth and potential pressure on wages for the Fed to not want to cut interest rates for the rest of this year.

Q: Let's turn to oil. In the past few months, oil prices increased by more than $10 a barrel. So while gas prices go higher, what is our view of energy prices? From an investment standpoint, what are your thoughts on energy companies?

A: Let me take the second question first. We like the energy complex as an investment. We like those companies that will help us find oil, drill for that oil more efficiently, and refine it into gasoline. The estimated price range that we have for oil is in the $60 to $70 range. We know it's currently above that, and our belief is there's between a $5 and $7 "agitation premium." We don't like to use the term "war premium," because we don't know that we're necessarily at war. But that agitation premium not only includes war, it includes agitation by speculators. In the financial markets, there is the opportunity for speculators to influence the price of oil, because they can buy oil-related contracts on financial exchanges. So we're holding to a $60 to $70 range for the price of oil for this year.

Q: Let's talk about real estate. Just how bad is it? Where are we in the cycle? Is it going to get worse? Are we close to the end of the housing recession?

A: It depends where you live, of course, and it depends on when your purchased your home. If you bought it six months or a year ago, you probably are feeling a little differently than if you bought it five years ago. We view the current residential real estate market as distinct and separate from the commercial real estate market. The commercial real estate market is booming. Rents are way up as the demand is constantly increasing. With the job market thriving, office space demand is driving commercial real estate to offset a big proportion of the decline in the residential side of housing.

The housing market is generally in a recession in California, Florida, New York, New Jersey, and Connecticut. Other sectors that did not boom, which doubled in price in a three to five-year period, are not experiencing the type of 10% or 15% declines in prices that are occurring in those other regions that I mentioned.

We look at a variety of indicators, and the forward-looking housing price indicators rose for about the first six months of this year. They just recently slipped back a little, and that leads us to conclude that by the end of this year and into early 2008, the housing recession's most negative period will be behind us. Therefore, in looking at GDP, housing will not be a negative contributor in the second half of 2008.

However, we still believe there will be another 10% downside this year for house prices. You have a nine-month inventory of unsold houses, a 15- or 16-year record high. In turn, house prices are likely to trend downward 10% this year, and there is a slight possibility that it could continue into the first half of 2008.

We don't agree with all of those individuals who look at one segment of our economy, the residential housing market, and conclude that the entire U.S. economy is going to go into a recession. I'd like to go back to this notion of dominoes. If you have a bunch of dominoes lined up, each represents a different segment of our economy: services, manufacturing, housing, education, healthcare, financial, leisure, and various other segments. If the majority of those segments are in a self-sustaining growth mode, those segments are strong and stable, so if one housing domino falls down and leans against any of the others, it's not going to knock over any of those other dominoes. This is where most of the alarmists and the perennial pessimists have been wrong all year; they've isolated the housing market and extrapolated it to the overall economy.

Q: With that said, would you attribute everything we're hearing about the meltdown in the sub-prime market to the alarmists? What are your views on this as an impact to the economy in general?

A: This falls under the category of "I don't know why it's a surprise to anybody." If you loan money to people who can't verify they have income and don't make much of a down payment, how can you be surprised when they're not able to pay you back? Furthermore, people who did not provide verifiable sources of income who obtained a loan at an introductory interest rate of 1% or 2%, but now it's 6% to 8%, are unlikely to be able to afford the higher payments. So it's no surprise to us that the investors in those types of bonds are experiencing a lot of pain and loss right now.

But I'll tell you why I think that's healthy. The longer those practices continued, the worse the decline would have been. We now know that it's finally over: loans that were not based on verifiable income, valuations at a 110% loan-to-value ratio, or interest rates of 1% that could go up six points in the first year. The sooner that was brought to an end, the quicker we're into the repair mode.

It is true that $100 to $200 billion are going to be lost, and the only concern that we have, quite frankly, is how that unfolds. If it unfolds in a period of a year or two or three, which is the norm for loans to not be paid and then foreclose and so forth, the economy can absorb it. If those loans happen to come crashing down and get liquidated, and this displacement occurs in a very short period of time, then I would be concerned that we would have one of those shocks that I referred to before, called a financial market contagion.

The losses that will occur are spread more broadly than they have ever been in our history. Commercial banks, which in prior housing recessions had most of the loans in their own portfolios, would then stop making other legitimate business loans and other legitimate service loans. Since they securitize and package loans, they no longer have all of that exposure. They are continuing to make credit available for valid business purposes, and this is why we don't believe a broad market credit crunch is going to ensue as a result of the sub-prime meltdown.

Q: Interest rates should matter a lot to us because of things such as mortgage rates and car loans. Interest rates also matter because they drive the interest income we receive on our CDs and our bank accounts. But interest rates also are connected to what happens in the stock market. Can you help us understand how interest rates relate to the stock market and what your outlook is for interest rates, bonds, and where these interest rates may be headed?

A: As we know, interest rates are competition for stock investors, and the importance of that cannot be underestimated. In the simplest form, investors can choose whether to seek return and risk from equities or from fixed income. We forecast that the Fed will be on hold for the rest of the year. We believe it is unlikely that the Fed is going to need to cut rates unless the housing/credit crunch spreads.

Q: So looking at the market, year-to-date the S&P is up by 8%. Ten sectors within the S&P 500 are positive. Eighty percent of the 130 sub-industries are positive for the year. Fifty-two industry groups recorded double-digit gains. The Index has advanced in 16 of the last 18 months. Garrett, what's going on here?

A: Well, here's the good news. The stock market has it right, as it is ignoring the perennial pessimists and the alarmists that have been telling us that the housing market is going to bring down the rest of the economy. The stock market reflects one thing: corporate profit growth is going to be about 8% to 10% this year. The market already has risen about 7% year-to-date.

Q: How does an expectation of 8% to 10% for corporate profits compare to last year and also with a "normal" year?

A: Yes, 8% to 10% for corporate profit growth this year is very good, given that last year it grew about 14% to 15% or even higher. And although it's down from the prior year, as I said, I like to use the saying we're in this nice glide path. We're not in a soft landing; we're in a glide path. And with the Fed on hold, job creation solid, corporate profits strong, equity investors happy and buying stocks; this is what is driving the stock market forward. We expect the stock market to do well for the rest of the year.

Q: We've had a long period of positive uptrend. We expect the market to do well going forward. What does that say about the risk level of the market after all these good years?

A: People have asked "Is it too late to get in?" Or "Is the stock market already at a new high? What should I do?" The advance in the stock market over the last five years has paralleled and been represented entirely by the growth in corporate profits. What that means is the valuation of the stock market has remained quite reasonable. What we mean by reasonable is a price-to-earnings ratio of about 16. We continue to like equities, and while interest rates have risen, they've not risen by any amount that gives us concern that fixed income going to be real competition for the equity markets for the rest of 2007.

Q: What is your overall large-cap equity total return expectation for 2007?

A: For 2007 we're looking at a total return for equities in the 10% range for both large-cap and mid/small-cap companies. Furthermore, if we focus on say those dividends and income equities, we're looking at 7.5% to 8.5%. International is already performing well above our expectation; we were expecting about 12% for the year, and year-to-date international equities have already achieved that. Fixed income is an asset class that, while we tried to like it, it's hard to like something that's going to pay you about 5% to 5.25%.

Q: If you're forecasting 9% to 10% total return for 2007, and the S&P is already up a little more than 8% year-to-date, do you feel that a correction is in store? What are the chances of that happening? And how long, if that does happen, would the correction last?

A: Don't wish for what you don't want. We have not had a correction in the stock market for many years of any material percentage, and it would be completely within our expectations for a 10% correction to occur. A 10% correction would be completely within the realm of a reasonable cyclical fluctuation in stock prices.

Q: How does Rochdale manage this risk?

A: First, for each client's portfolio, we manage risk, or downside exposure by the way we allocate their assets, depending upon whether they have more growth or large-cap or dividend and income or fixed income. That is the first level of protection.

The second level relates to the types of stocks within each asset class. For example, we have some limitations on the "red zone" stocks or the excessively risky stocks, overall and on an individual client basis. We also like the dividend-paying stocks. As you know, dividends will be paid in aggregate for that part of the portfolio almost regardless of what happens to the stock price in any given week or month.

So we remain buyers of stocks on corrections. Actually, we would be happy if they pulled back a little bit; it would give us an opportunity for us to buy other good global, domestic, and dividend companies that we like at more attractive valuations.

Q: So which asset classes is Rochdale focused on for 2007?

A: The international asset class remains at the upper end of our recommended target allocation range. We expect international markets to continue to do well. We also like the larger global domestic companies, and they range across the board from the energy sector to the capital goods sector. We're very strong in capital goods companies and overweight in industries within that segment. We also favor financial services, insurance-type companies, and the energy sector.

Q: The Rochdale Atlas fund up over 30% in term in 2006, and it's up another 18% year-to-date. Yet, you feel the global economy is still strong, and you feel the growth is going to continue for some time, so you're comfortable having a full weighting in international equities for our clients. Is that growth really sustainable?

A: A lot of people have asked about the Atlas fund going up 110% over the last several years, and they've become concerned that it is going to come crashing down. There is a basis for that fear. As you know, certain foreign markets are very risky, or not very risky but have a lot of fluctuation potential. We agree and accept that at any point the international markets could experience a correction. I think it was in 2006 we had a correction of 15% or 20% within a reasonably short period of time. We don't expect that to occur, but if that were to occur we'd be fine with that, as we are long-term investors.

Q: There's been a lot of news in the media again on leveraged buyouts (LBOs) and private equity firms and how they are driving the market.

A: There is a great misunderstanding about private equity and LBOs. It starts with those individuals located in Washington, D.C., who have a strong desire to tax or change the tax situation for private equity. That would not be necessarily as negative as Wall Street is arguing it would be, but it clearly would not be a positive if that were to occur.

Performance quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted. The most recent month-end performance can be found on our Web site at www.rochdale.com. Total returns do not reflect sales charges, which, when applied, would lower returns.

Investing in international companies carries risks such as currency fluctuation, interest rate fluctuation, and economic and political instability.

Standardized returns for the Rochdale Atlas Portfolio for the quarter ended 6/30/07 are as follows: Average Annualized Total Return at NAV (Net Asset Value) for 1-year, 3-year, and 5-year: 39.86%, 31.00%, and 22.95%, respectively. Average Annualized Total Return at POP (Public Offering Price, reflecting maximum front end sales charge of 5.75%) for 1-year, 3-year, and 5-year: 31.82%, 28.45%, and 21.50%, respectively.

An investor should consider carefully the fund's investment objectives, risks, charges and expenses. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-245-9888, or visiting www.rochdale.com. Please read it carefully before investing. RIM Securities LLC, 570 Lexington Avenue, New York, NY 10022.

The unsubsidized total annual fund operating expense ratio for the Atlas Portfolio is 1.71%.

Let me tell you what our takeaway is. If I look at a stock on the publicly-listed New York Stock Exchange or on the NASDAQ market, and I see it's trading at $60, and a company comes along and offers $70 for that stock the next day, and the people that are making that $70 proposal to buy that entire company are smart, have all the financing they need, and are proven operators of businesses, that tells me that the stock value was undervalued on the U.S. stock market.

The fact that we have a lot of buyouts occurring indicates to me that the corporate structure and the operational behavior patterns embedded in many of the businesses today that are being taken over are either inefficiently structured from a capital perspective, inefficiently operated, not taking advantage of global outsourcing, or not taking advantage of other types of distribution channels. That effort brings available financing, creates better efficiencies, changes the mindsets of management, and eliminates or reduces the self-dealing that we've seen be prolific, with CEOs walking away with tens or hundreds of millions of dollars of compensation. We view that as generally positive in regards to supporting or validating our view that the public equity markets are reasonably valued.

We're not here to say that the private equity people should not be making as much as they're making, or that they should have a certain tax rate, or that all of these takeovers are going to work out great. We're just saying, as a validation for what we do in looking at publicly priced companies, we like the fact that the takeover activity substantiates the market's current value.

Q: Switching gears, I keep reading more and more about hedge funds. I know when I went to business school, the word hedge meant to reduce risk, yet a lot of articles that we read about hedge funds don't necessarily make them sound so safe. What is a hedge fund, and how might such an investing strategy fit within a Rochdale client's portfolio?

A: Well, if you passed that class that you took in graduate school, you were asked the question "Are all hedge funds risky?" and you answered "No." Hedge funds are, in one way, descriptively like mutual funds. Nobody would say that all mutual funds are risky. They would say it depends on the classification and the investment objective of the mutual fund. The same exact question needs to be asked when referring to a hedge fund.

There are different types of hedge funds. There are hedge funds that use lots of leverage, have a single narrow strategy, and those that engage in volatile underlying assets. Those funds are more volatile than the U.S. stock market.

At the other end of the spectrum, there is a set of hedge funds that are a blend of different strategies which do not use or abuse financial leverage. However, because of the sophisticated way that they hedge against big ups or big downs, they take away those big up and downs and they actually have a substantially lower level of volatility than the U.S. stock market. Many of those lower or moderate volatility hedge funds come down into the neighborhood of bond-like volatility, with an annual standard deviation of say 5% to 7%.

If you're talking about those moderate or low-volatility hedge funds, it is the expectation that adding a 10% allocation to a fund of that sort will bring some benefits. It will bring diversification that doesn't exist within the traditional asset classes, with correlation being lower than some of the other asset classes. You will have the opportunity to make money when some of your more traditional long-only assets are not making money.

Q: I want to ask you some broad questions about some of the investing sectors. It appears that you prefer large-cap stocks over mid-cap and small-caps. For the past few years, you've been saying that large-cap was going to outperform mid and small-cap sectors, that did not happen. This year it doesn't seem as though it is greatly outperforming mid or small caps either. Please give me your perspective on large-, mid-, and small-cap domestic stocks.

A: Until this year, we were not really of the view that large-cap was going to outperform mid- or small-cap. Our view is more of a normalization of returns between the two asset classes. We're now a little more balanced in our outlook between large-cap versus mid-cap. So we're not ignoring the mid-cap by any stretch, but we're not overemphasizing them to the disadvantage, if you would, of large-cap.

We also think in terms of growth and value. We have been more value-oriented in large- and mid/small-cap, but we're now kind of right down the middle between the growth and value allocation.

Q: It is obvious that you're not big on bonds. Do you have any different opinion about high-yields or convertibles? What about floating rates in the bond sector?

Thank you for bringing up bonds. It's not that we don't like bonds; because bonds represent a very valid and bona fide asset class to protect against downside risk, and that is always beneficial to have in a portfolio, given a person's age and risk and suitability. Our notion, though, is that there is a potential for the economy to do slightly better as the year progresses, and in 2008, if it continues to progress as expected with 2.5% to 3% GDP growth, there is a slight chance that rates could go up. I don't want to be overweighting fixed income in an environment where six months from now I could probably be getting a little bit better yield and certainly avoid a little bit of the downside.

Q: Even though commercial properties are doing well, domestic REITs are not. With that in mind, could you provide some commentary on utilities, natural resources, and the energy sector?

Convertibles, floating rates, REITs, and utilities are better income-producing proxies than fixed income. We tend to like those more than fixed income, and we're using them as equal substitutes. However, there is obviously risk in a stock dividend REIT versus just a straight treasury bond.

Utilities are always safe and sound, generally speaking. We are moderately positive on utilities, but we think the economy is going to do a little better in other areas, so I wouldn't be overweighting utilities. We recommend holding overweight positions in natural resources and materials such as aluminum or energy.

Q: Despite commercial properties doing so well, why do you think the REITs have been doing so poorly this year?

A: In order to answer this question properly, you have to look at a two to three year period and discuss the matter with an expert in the field such as Rochdale's David Abella. In anticipation of this call, I asked him to give me his grades on these different areas. Part of the reason why the REITs haven't done as well is the fact that interest rates have gone up. This has taken away a bit of money and, in turn, the demand for those stocks has declined and gone into fixed income. Clearly the returns last year in those categories in our fund were 20%-plus.

I've often said that if I earned 20% last year in my fixed income substitute and took on a little bit more risk, and now I just locked down my bonds over a two-year period, 20 plus 5 is 25% with a 12% average on fixed income, I'm going to lock in those gains and take all my risk off the table.

Let me give you the grade that we give the components of our high dividend and income strategy. In terms of valuation fundamentals, we are generally positive on REITs. We would generally grade REITs with a B. Master limited partnerships we give a B+ and utilities a C. Other categories, such as shipping companies, we give a B for yield.

Q: Recently, David Walker, the U.S. Comptroller General, expressed his concern over the budget deficits and how they're affecting national debt, and the ballooning requirements of the Medicare system and how that is going to affect markets in general. Do you have any thoughts at all on his concerns?

A: I don't know David Walker specifically, but I spend a fair amount of time looking at Medicare, Medicaid, and Social Security. Of the three, the Medicare issue is a multiple of the Social Security problem, and everybody on this call probably understands that the Social Security system has major variances between funding and outflows occurring over the next 15 to 20 years.

Q: That's a good point, but it is true that the Medicare system is really what's going to put the burden on individuals?

A: Yes, and my take there is it's an indictment of the ineffectiveness of our elected politicians to address an issue that any elementary school student would raise their hand and say, "A minus B looks like it's at great risk of exploding out of control. This is not a situation we should sustain." Any elementary school student would say something should be done, yet our elected politicians kick the ball down the court or kick the can down the road because it's not something they want to be dealing with. It's a tragedy. It will raise taxes in the future. It will burden the next generation of individuals with higher taxes and less likely benefits of lifestyle and all of the consequences that we know. Was it Cheney or somebody who said, "Deficits don't matter as long as I'm going to be out before they come crashing down." That's the problem.

It is a real problem, but we don't think it's going to affect our investment outlook for the next 6 to 12 months. That doesn't mean that we don't care about it, or that we don't think it's a real problem, or that we don't wish more would be done about it, but right now, I can't get those people to pay attention.

Q: Your response is political, but as a financial and credentialed professional, what is your take on it in say a five- to ten-year period? If not corrected, is this something that is going to have a very adverse effect on the fixed income markets and/or the equity markets as well?

A: I'm actually apolitical on the issue. What I'm saying very simply is that the people who can address this are not me or you. It is up to the people we elect in the political sphere to do something about it, and they're not doing anything about it. That is the fundamental problem.

Q: But the question I'm asking is, what can we do about it? What should we be looking for in the environment to avoid what is really kind of a large problem rolling down the road here?

A: Looking ahead to the next 12 months, I would change nothing about our investment recommendations in relationship to this tremendous problem going down the road. I believe that ultimately what will happen is taxes will go up substantially over an extended period of time. I believe benefits will be reduced substantially over an extended period of time. The qualifications for those getting benefits will be changed, and the rules of the road will be altered. The commitments that were made will be broken, and this whole problem will be brought into some sense of equilibrium through a combination of a shared sense of pain, including the pain of people invested in certain asset classes. I can't predict which ones will be worse affected now. It could be the healthcare industry as all the healthcare companies could be put on some type of pricing control mechanism. I can't foresee that, but it clearly will be a comprehensive set of shared broken promises, raised taxes, reduced standard of living, and things of that nature.

Q: Could you speak for a moment to the growth versus value issue? Many clients follow some of the financial gurus that are strictly growth-oriented or value-oriented. What is your take going down the road for growth versus value?

A: We have, for the prior several years, been overweight value versus growth. This year we're down the middle 50/50 and the reasoning for that is that the valuations of the companies known as cyclical or value has now risen, such that we think the prospects for both value and growth are presently about the same. That is why we're now balanced between growth and value looking out the next 6 to 12 months.

Q: Some clients and advisors have a definite interest in commodity-related investments, which have done extremely well in the last few years. What is your current outlook for the next year in that sector?

A: Astute investors in this sector have always understood the global dynamics of demand, whether it's for copper, aluminum, or steel. We're optimistic on the outlook for the demand for those resources that are required to build roads, infrastructure, power plants, and airlines.

We are adding one or two of those companies to our buy list as a reflection of that, as we are overweight in the materials and energy sectors. Additionally, the way we address commodities is through our hedge fund via an allocation within that fund of funds strategy toward those commodity characteristics. We think the global growth in China, India, Korea, Taiwan, and Brazil, is set to continue for at least the next year.

The Standard & Poor's (S&P) 500 Index represents 500 large U.S. companies.

Investing in small and medium-size companies and REITs may carry additional risks such as limited liquidity and increased volatility.

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