Kintyre Investment Letter

Fourth Quarter 2007

SUMMARY:

2007 was a turbulent year that saw the housing market take a dive and the credit markets seize up. Many financial stocks were hit hard, but overall returns on the year were modestly positive.

Quarterly Market Commentary

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. The earnings of just about any company that was involved in homebuilding or lending were crushed. As credit tightened and the housing market suffered, investors became more and more worried about the overall economy, triggering stock declines for many consumer goods companies. Companies with significant foreign-based earnings did well including (generally) energy, technology, and materials companies. Overseas stocks also delivered great returns.

For our portfolios, our equity managers underperformed overall, while our bond managers outperformed, leading to an overall performance with modest gains that were slightly under target for each allocation model over 2007. The strong performance of growth stocks in 2007 contributed to this discrepancy. Historically, growth stocks have not performed well during periods of slow economic growth, and therefore we believe a shift towards over-allocating growth stocks is not advisable at this time.

The significant January declines in the stock market reflect investors' growing fear that a recession may be imminent. Many investors are wondering if it makes sense to become more defensive to avoid any further volatility and potentially further declines in stock prices. Others are wondering about when the declines might lead to compelling investment opportunities being created.

Continued on page 2…

Kintyre News

I continue to be grateful for the close personal relationships I have developed with my clients over the years. This was especially true in 2007, as I asked for your patience while I attended to an unforeseen medical crisis.

I was fortunate to be able to check email and work remotely. To enhance these capabilities, I've recently invested in new phone technology which allows phone calls to ring simultaneously at Kintyre's offices, my home office, and on my cell phone. While I have no expectation of being out of the office for any significant time in 2008, I'm following the scout's motto: "Be Prepared!"

The Kintyre Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share our investment thinking and provide general advice to the public. Please contact us for advice specific to your situation.

IN THIS ISSUE:

Market Commentary........1

Kintyre News 1

Personal Finance 3

Quarterly Market Commentary (continued)

No doubt many investors are increasingly concerned about recession and are now reducing equity exposure below their normal targets. But recognizing the economic weakness as it becomes apparent is the easy part. Identifying it before the market recognizes it is far more difficult, yet this is the only way that reducing equity exposure will actually add value. In fact, predicting the timing of recessions with respect to the stock market is very difficult and attempting to do so often detracts from long-term performance. Moreover, stocks have already fallen quite a bit from their peak, and in most previous cycles, patient investors who wait out declines of this magnitude do well over the multi-year period that follows.

Likewise, given the recent stock market sell-off, by many measures stocks now look cheap. The problem is that most valuation metrics are based (partly or mostly) on what companies have already earned rather than on what they will earn going forward. Slower earnings growth going forward, or an outright decline in earnings (an earnings recession) would mean stocks are not as attractively valued. Profit margins have been extremely high relative to history, resulting in earnings that are way above their long-term historical trend. In the past when earnings spiked above trend they have always come back at least to trend, and in many cases, have temporarily gone below trend. This strongly suggests that currently, the earnings numbers used to measure valuations are unrealistically high, and the resulting valuation measures are misleading. Therefore, we would want a bigger decline before we would move to an overweighted position. Predicting the bottom of a decline is just as difficult as predicting the peak, and therefore any shift towards stocks, if it does occur, will likely be early. As painful as this would be in the short term, it would set up long-term investors in our portfolios to capture higher returns by holding a higher equity allocation prior to the start of a new market cycle.

In the short term, markets can be driven by emotions like greed on the upside and fear on the downside (right now markets are clearly driven by fear). But because short-term drivers of emotion are inherently difficult to predict, it is impractical to base an investment strategy on doing so. Fortunately, it is not as difficult to analyze longer-term business and economic fundamentals with more confidence, and history has demonstrated that fundamentals and stock prices will converge over time. By basing a strategy on longer-term fundamentals and valuations, we can look beyond short-term market declines that might trigger some investors to become defensive at inopportune times.

A core aspect of our approach is risk management. Each client's portfolio is designed around time frames, goals, and each client's financial and psychological capacity to assume risk. While we can never make guarantees, we can say that we manage our portfolios in a way that we think makes it unlikely that we will violate these loss thresholds. But when markets decline sharply, we realize that it can be difficult for investors to prevent fear from driving their investment decisions—even if their portfolio is not exceeding the maximum loss they understood could occur in the course of a long term investment strategy.

Looking ahead, the impact of the housing slump and lack of liquidity in the credit markets has increased the level of economic risk, and recession is a clear possibility, though not necessarily a high probability. As our portfolios are designed to take advantage of long-term fundamentals, any changes are unlikely to be dramatic. However, clients should understand that the possibility of a rough year lies ahead. They should also understand that this is not an outcome that can be predicted with high confidence. We've been surprised by positive market returns many times over the years. So we focus on doing our best to maintain adequate risk protection based on the risk tolerance of each investor, while keeping our eye on the more important goal of long-term returns.

We know there will always be uncertainty in the markets, but what remains consistent for us is this framework for how we make consistent and disciplined investment decisions.

Please feel free to contact me if you have any questions. Thank you for your continued trust and confidence.

Systematic Saving to Establish or Increase Cash Reserve

What is systematic saving?

As its name implies, systematic saving is the process of saving a portion of income on a regular basis. It is important because establishing or increasing a cash reserve should be the first savings objective of a financial plan. Further, most people do not save on any systematic or regular basis, so the plan's long-term success is likely to benefit from early development of this excellent habit.

Always pay yourself first and create an excellent habit that will reward you for a lifetime

For those who do not yet have financial security and independence, systematic saving and building a cash reserve are the first steps (managing debt is a close second, except in dire situations). You should look at systematic saving as paying yourself before passing what is left over to others. Money spent is money that usually must be replaced by working for it. Or, as the adage goes, a penny saved is a penny earned.

Review the automatic and planned approaches to systematic saving before you choose

With an automatic savings plan, you formally arrange with an employer or financial institution to periodically set aside a specified amount of money from your income or an existing account. A planned approach differs from this in that savings are not set aside automatically, but require that you deliberately set the specified amount aside every period. Automatic plans are preferable because the transactions are made by others, thereby avoiding a temptation to divert funds (out of sight, out of mind). Yet, planning for periodic savings, which is often part of a budgeting process, is an excellent alternative, especially if the routine savings amount is viewed as a mandatory bill payment.

Automatic payroll savings plans

Today, many companies offer a payroll savings plan as an employee benefit. These plans automatically withhold an agreed-upon amount from each paycheck and deposit it in a savings or money market account on behalf of the employee. The employee usually is free to start and stop the withholding process and to occasionally change the amount withheld, provided changes are within reason and according to the plan's established guidelines.

> **Tip:** Always be sensitive to the rate of interest paid on your money. If the rate is unusually low, it is sometimes advantageous to move large sums to an account that is low risk but offers a higher interest rate, such as a money market account.

Automatic account transfers

Most financial institutions offer depositors an opportunity to have funds automatically moved between the accounts on a periodic basis. While not a savings plan as such, it provides a convenient way to save, regardless of the objective. These plans tend to offer significant flexibility in starting, stopping, and altering the amount being transferred, plus a selection of several types of accounts.

Banks and credit unions--Most people keep a checking account and a savings account at the same institution, usually to capitalize on fee discounts and other benefits. In addition to basic savings and checking accounts, financial institutions also often offer money market deposit accounts and other types of term deposit accounts that generate higher returns, in exchange for reduced access to the money deposited. Having multiple accounts in such a location brings the option of having a specified amount transferred periodically to an account you designate for cash reserve savings.

> **Example(s):** Jane arranged with her employer for the automatic deposit of her paycheck into her checking account at the ABC Bank. She now can request that the bank automatically transfer $500 each month to a money market deposit account that she also has set up as part of her cash reserve.

Brokerage firms--More and more, brokerage houses and large mutual fund companies offer accounts and services similar to those of banks (the reverse is also true). Consequently, you will often find opportunities for automatic payroll deposit and automatic account transfers outside of banks. If you hold investment securities with a brokerage, for example, you might arrange to have their earnings automatically deposited to a money market mutual fund rather than automatically reinvesting the earnings.

Budgeting for regular savings

Whether or not you use a budget to manage your financial activities (see Budgeting), you can plan to regularly contribute a specific sum to your cash reserve. If you do use a budget, then the amount you save should be considered a regular expense, similar to other high-priority expenses. Alternatively, you can save regularly in the same way even without a formal budget.

Choose one savings approach or a combination depending on availability and how aggressively you need to save

When implementing a systematic saving plan, begin by selecting the option that best matches your needs.

You may find that a more aggressive approach to saving than a single-step approach would achieve is necessary. Then, add a new approach to those already in place to increase the savings rate.

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