

Chapin Hill Advisors, Inc. Market Comment
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Musical Chairs....Has the Music Stopped?

We have witnessed increasing volatility in the stock market and 100 point swings are becoming common occurrences. The last 30 minutes of trading has become a nail-biting experience as the market vaults up as it did today or plummets as it did this past Friday. Institutions remain firmly in control and the pundits on CNBC will tell you why everything is just fine and you should remain calm.

The trading in the last month has erased the gains on many indices and brought some, such as the Russell 2000, into negative territory. At its peak in mid-July, the R-2000 was up 8.6%, but as of last Friday, it was down 4.1%. The S&P 500 was up 9.5%, but as of last Friday, was up just 1%.

The buy and hold crowd will tell you that a 5% "correction" is nothing to be concerned about and that most of the time a correction of this magnitude has happened, the market has rebounded afterwards. So don't panic, fasten your seatbelts and hang in there for the long term.

The problem is that most investors become somewhat apathetic when the market rises but may become very nervous when the downdraft hits. You need to know your risk tolerance and how much a 10% correction in overall market will affect the value of your account.

We are a nation of ADD investors and no one seems to recall that by June 2006, we had barely positive returns for most indices and a -7.89% return for the Nasdaq. The Nasdaq finished the year with a positive return of 7.2%, meaning that from the June 30 period, it achieved a 15% run. The S&P 500 finished 2006 with a 14% return but 12% of that was from August on. Add on the run-up into July of 9.5% and you have a 21.5% return from August 2006 through mid-July 2007.

There was no negative correlation in foreign equity markets as they, too, took it on the chin. Most European indices are now flat for the year. The leaders of the last rally in most markets were the hardest hit. Surprisingly, the price of gold also pulled back, while oil bounced around near \$80 a barrel.

No market goes straight up or straight down. There are always periods of readjustment. The flood of liquidity, plethora of deals being done, stock buybacks and general optimism about the economy and earnings outlook drove the markets up since last July/August. Goldilocks reigned!

However, the focus can shift quickly without any life-shattering headlines. What precipitated the fall of the last few weeks? Was there one event which told us to watch out below? No, not one event, but rather a series of announcements about lack of liquidity in some financial institutions, concerns about deals now closing, some weaker earnings and the closing of several hedge funds and one foreign bank.

Now the focus is on the leveraged balance sheets and concerns about liquidity. The news (and rumor mill) quickly builds and cascades into massive selling, driven by the large institutions. Leverage is a wonderful thing when the markets rise but it hurts on the way down and can cause rather minor losses to grow rapidly.

Over the past few years, many of the large institutions have increased the leverage on their balance sheet. As of 5/31/07, Bear Stearns had leverage of 31 times its' equity of 13 billion, creating a balance sheet of \$423 billion. Goldman Sachs, a well regarded investment bank, has increased its leverage from 18.7 times in 2002 to 24.5 times currently. This brings their balance sheet to almost 1 trillion dollars!

On Monday, the markets rallied in the afternoon on hopes that the Fed would change the language in their comments at today's Federal Reserve meeting. The day finished at the highs of the day with the biggest one day move for the Dow with gains of 2% or more for the major indices.

This mornings trading muddled back and forth until the announcement at 2:15pm. Then the roller coaster ride began with the Dow down over 100 points by 3:30pm, but finishing plus 35, a gain of 0.3% while the Nasdaq composite and the S&P added 0.6% each.

So, has the game of musical chairs - with the massive amount of liquidity and leverage fueling the markets - ended?

Only time will tell; however, we prefer to take the cautious approach. Be sure your portfolio meets your overall risk tolerance. Consider hedging your portfolio with alternative investments which hopefully have small correlations with the traditional markets. We have been bears on real estate and financial services for some time and this position has finally paid off handsomely.

It is difficult to add these types of hedges without professional advice, so review what your present portfolio structure is and whether you can add some protection, or move your portfolio to a more conservative allocation if you cannot tolerate the downside potential.

As always, feel free to call us with questions or comments. Please pass this on to friends, family or colleagues who would be interested in receiving our comments.

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