



Investor's Corner Newsletter

August 2, 2007

Model Portfolio Returns:	2006	YTD 2007
Modified:	24.58%	8.09%
Pure:	20.62%	1.21%
Model Trust:	19.07%	6.13%
Challenge:	19.45%	4.43%
S&P 500:	15.85%	4.25%
Bond Fund:	4.60%	1.30% yield 4.95%

(Note: all portfolio return figures include reinvested dividends and, if applicable, capital gains. Portfolio performance is monitored using Morningstar resources.)

..Just so, investors are loathe to question generally accepted knowledge. If we started doing so, we might soon realize the market exists solely to humiliate us as much as it can for as long as it can for as many dollars as it can. I refer to the market by its proper name, "The Great Humiliator" (TGH for short). I've come to accept that my goal is to interact with TGH without getting humiliated too much. TGH is an equal opportunity humiliator. It doesn't care if you're rich or poor, black or white, tall or fat, male or female, crippled or an Olympian. It wants to humiliate everyone.

Ken Fisher, *The Only Three Questions That Count*

Well, we were sailing along in mid July, model portfolios up between 8 and 14 percent for the year, when all of a sudden a cold wind of market uncertainty blew in. Now, being a skeptic by nature as well as profession, I tend to try my best to disconnect from the noise that's associated with the markets and keep my eye on the longer term and bigger picture. I would be lying, however, if I said that swings and volatility didn't affect me somewhat—I guess that just comes with the job description. So, as an exercise in actively resisting emotion and certainly open-ended fear, I thought it would be productive to identify and break down some of the major issues that are swirling around the market these days. Issues that can be brought to light and analyzed can then be priority-weighted and mentally filed (or, as it were, circular filed).

Leverage is one of the issues that have been mentioned most as a cause of recent consternation. Many of the financial entities-hedge funds, mortgage companies, banks-reporting problems over the last several weeks were using leverage-that is, borrowed money-to buy a book of assets-sub-prime mortgages, collateralized debt obligations (CDO's), etc. Some were leveraged as much as ten times-that is, they owned ten times the assets of their capital. That kind of exposure can make a money manager look like a genius if he's on the right side of the trade, but if the market moves against him-watch out! And, in the dog eat dog world of Wall Street, the realization that a fellow money manager is in trouble causes sharks to start circling. They will determine the specific assets in a portfolio, spread the word to fellow pros in the market, and then stage a buyer's strike against those assets, with hopes of ultimately forcing liquidation of the assets far below fair market value. Indeed, I think that this forced selling has been the biggest reason for the surge in volatility over the past several weeks and explains a good bit of the price action over that time frame.

Leverage is also at play in the housing market, where a small down payment can control a much larger house or piece of property, with similar problems (absent the liquidity) occurring if house prices go down while mortgage payments adjust upwards. Leverage occurs in the commodities

markets as well, when a speculator can leverage investment capital to own a much larger position in a commodity, currency, etc. (For instance, leverage gone awry in the natural gas futures market played a key role in the Amaranth hedge fund blow up last year.)

Risk exists in all financial assets. Prudent evaluation and diversification of risk, known as asset allocation, is the primary source of investment out-performance (or underperformance) over time. Risk tied to low-grade borrowers, whether individual, corporate, or even national (Venezuela anyone?), should be avoided at all costs, for when low-grade credits default the underlying assets are frequently not valuable enough and/or liquid enough to satisfy the debt in a timely fashion. After all, they're called "junk" bonds or "sub-prime" loans for a reason. AVOID!

Fear is the financial market's evil twin of greed. Fear causes rash, emotional decision-making and ultimately impels investors to sell at the bottom. Financial markets are given to periodic bouts of fear-based selling to shake out weak hands. Recent fear, and the subsequent flight to quality in the bond market, has unsettled veteran stock market investors who have learned from experience that the bond market sees trouble long before the stock market. However, the bond market is notoriously skittish and frequently telegraphs fear that proves to be unwarranted.

Opportunity arises from applying knowledge and discipline and from overcoming fear. I sometimes feel opportunity when the market is reaching new highs on good volume, but that has been a tough road this summer. New highs have prompted quick sell-offs for several months now, almost requiring investors to purchase when the market looks its sourest. Investors with a lot of cash on the sidelines will undoubtedly see some good entry point opportunities in the markets when the sub-prime and housing slowdown fears finally play out. Or the Fed cuts interest rates. Or...

Are we affected? As clients and readers know, I am a big fan of brokerage firm Goldman Sachs (GS). It is one of my firm's largest stock positions. Goldman uses leverage in some of their trading activities, but they have not yet reported any problems due to subprime or CDO leverage exposure. Additionally, the *Wall Street Journal* reported on July 27th that Goldman was going to open a \$20 Billion fund investing in corporate debt, presumably to take advantage of recent turmoil in the credit markets. I think Goldman is a smart group and I am glad they smell opportunity.

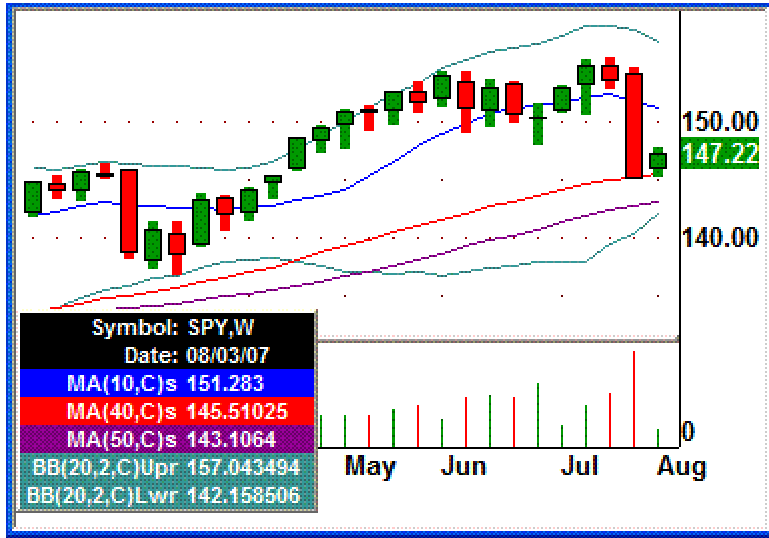
Banks such as Gateway (GBTS), BB&T (BBT), Bank of America (BAC), etc. all have loan portfolios made on real estate, and are thus potentially subject to housing and real estate-leveraged loan default. This will have to be monitored on an ongoing basis. The banks and homebuilders would definitely benefit from a Fed rate cut, as would your local Realtor.

I think our exposure to the energy and natural resources sectors is warranted, too. One look at all the fuel inefficient vehicles on the Bypass should tell you all you need to know about owning oil and oil related stocks. I am still learning the intricacies of how the individual sectors trade. Chevron (CVX), Devon Energy (DVN) and Valero (VLO) are oil names worth owning. Our tanker stock, Nordic American Tanker (NAT) just announced it was issuing stock to grow. NAT has proven that it is a good steward of our capital and should be owned, especially on weakness.

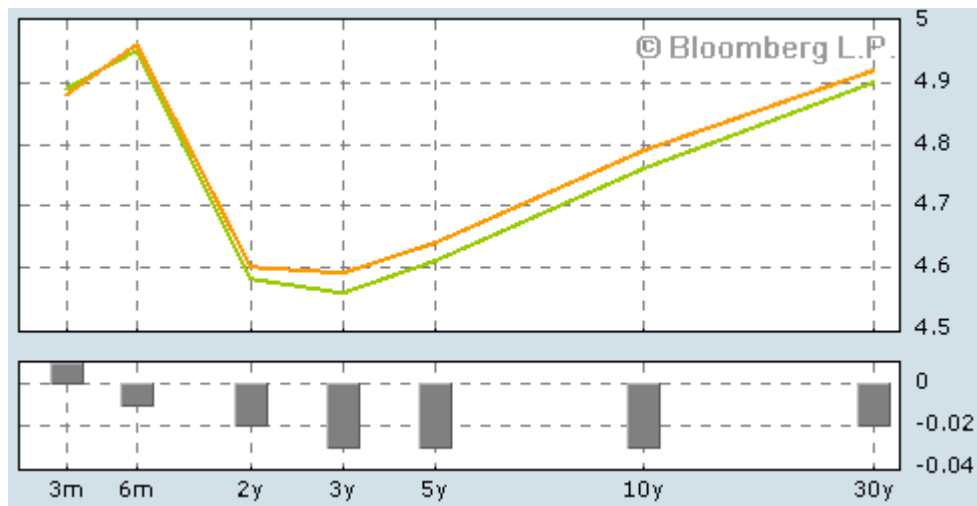
As far as the natural resources sector goes, I think one of my clients hit the nail on the head when he said, "If it come out of the ground, own it!" (Okay, maybe not coal, but you get the idea). Continued strength in natural resources-heavy economies and the weak US dollar versus foreign currencies adds credence to the case for exposure to international stocks as well.

Takeaways: To this point, we have largely avoided leverage-related crisis in our portfolios. Do not own or invest in low-grade debt! Be very careful using leverage for an investment. Within the financial sector, know what you own, and don't be afraid to be picky. High quality, "Best of Breed" assets bounce back higher and harder than their low quality brethren. And if you have been thinking about getting more involved, let's fire when we see the whites of their eyes.

Charts: S&P 500:



Yield Curve:



Good investing,

Will

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