



PERSPECTIVES

JULY 2008

NUMBER 40

Second Quarter

Talk With Us

Doom and gloom; if you read current headlines, an investor could think the worst. However, the economy is still growing, albeit slowly. Conditions in energy, mining, and agriculture almost could not be better. On the other hand, conditions in housing, banking and many consumer areas are just the opposite. For the first half of this year, as well as the second half of last year, fear that the bad parts of the economy would overwhelm the strong parts gripped many investors. That does not seem to be happening and RCM does not believe it will (see the **Forecast** section).

However, in the stock market fear often has to run its course before logic and perspective can return. Trends like this do not persist indefinitely; they burn themselves out. The current trend has been in place for over a year now. We believe we are getting close to the end of this one. After all,

monetary policy is now accommodative, fiscal policy is aggressive, and many troubled businesses are making major adjustments to their operations and financial structures. It may seem harsh as firms make brutal cuts and ask for concessions from workers, but they put themselves on sounder footing quickly.

Approaching the end of the quarter, energy prices were the major concern. By then, the liquidity lockup in the financial system had abated and losses in sub-prime mortgages and a myriad of other exotic financial instruments had been recognized and accounted for, but the ever increasing price for fuel led to concerns that secondary effects on credit and economic activity would again overwhelm the progress that had been made. (To see if that is what we believe will happen, see our forecast.)

It is said that only fools make predictions. However, it is unavoidable in investing. RCM has a process to make these assessments. In our industry's parlance it is called our top-down view. It starts with "the big picture" and works down to sectors and industries. It is never static, but continually reviewed.

As information comes in, our investment committee constantly compares the reality that emerges with what has been predicted. The committee has to make judgments as to what information is significant and what might be noise, or extraneous to our basic assumptions. When confronted with information contrary to our expectations, we have to alter our assumptions. We then have to analyze how our investment posture has to change to accommodate the changes in outlook.

Part of our investment process is to have internal hedges built in. This allows us to be wrong, but not have to change everything. One example might be our view of energy today. RCM feels that energy prices reflect increasingly tighter supply in the face of rising worldwide demand. However, there is the possibility that some of the rise might also be a response to increasing speculation. Therefore, we have not made an all or nothing bet on energy stocks. We watch our weightings and take some profits along the way. In the case of a swift correction in energy prices, it would not devastate our clients' investment portfolios.

Our constant vigilance and review of our assumptions help us avoid getting completely off track. We realize that most assumptions start out being somewhat off and get better with adjustment. We are humble in our approach. Furthermore, we state our assumptions in this

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Forecast

Economy

We predicted a mild recession that affects some sectors severely, while other sectors are hardly touched. So far, that prediction has been borne out. Housing, construction, and banking were the first sectors to feel the impact of the subprime crisis. At the same time many manufacturing industries, mining firms, the oil and gas business, and the agricultural sector stayed strong or even got stronger.

However, just as credit markets seemed to

begin to emerge from crisis, energy prices, especially gasoline, increased dramatically. This added more pressure to an already strained consumer sector. As a result, other sectors, especially consumer related, such as retailing, travel and leisure, restaurants, and autos began to be affected and slowed down too.

Business conditions outside of the U.S. mostly seemed to be unaffected. Asia, especially China, has been booming, Europe has held up relatively well, Russia and parts of South America also are strong. (World-wide growth

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MAJOR INDICES AS OF 6/30/2008

| | |
|---------------------------------|---------|
| Large Cap Stocks (S&P 500) | -12.83% |
| Dow Jones Industrial Average | -14.44% |
| Mid Cap Stocks (S&P 400) | -4.57% |
| NASDAQ Composite | -13.55% |
| Small Cap Stocks (Russell 2000) | -9.97% |
| MSCI EAFE | -12.70% |
| Lehman Corp. Bond Index | 1.53% |
| Inflation | 4.2% |

(EQUITY INDICES ARE THREE MONTH RETURNS EXCLUDING DIVIDENDS)



Forecast *(continued)*

is expected to be 4% in both 2008 and 2009.) The question remains whether a weak U.S. economy drags down the rest of the world or does strength in the rest of the world buoy our economy and mitigate our down-turn? RCM believes that the international economic strength is already off-setting some of the weakness here, helping keep employment up, providing much needed capital to shore up our banking system and providing new markets for our goods and services. (U.S. exports have been increasing at about 8% annually, six times faster than imports.)

RCM has stated that increased globalization would be a source of strength and stability for all economic participants. So far, this first real test seems to be bearing out this prediction. The economy is adjusting rapidly to the new realities, markets are working, housing is bottoming, and the future looks brighter. However, we are carefully watching and are ready to respond should the facts change.

Equities

The U.S. stock market has had a tough year so far, (see the major indices section). However, the response is not nearly as bad as in many past cycles; especially considering the magnitude of the problems in housing and in

the banking system. That is because there are still many areas of strength in our economy.

RCM believes that this condition will persist for some time yet, but the resolution will be that weak sectors begin to recover while the strong areas remain strong. The factors behind the strength in sectors like energy, mining, some manufacturing, and agriculture are durable. They are a result of rising expectations and economic growth in many other parts of the world.

Fixed Income

Interest rates are rising. Inflation is back and can not be ignored. The Federal Reserve is holding very short term rates low, but investors are demanding higher rates for lending money for longer terms. In essence the yield curve is steepening, e.g. the rise in rates for longer and longer maturities is increasing.

RCM has predicted that this would occur because interest rates had not been adequate to cover current inflation much less the specter of rising inflation. Rates will probably go higher still and sooner or later the Fed will need to raise short-term rates to combat inflationary expectations.

Talk With Us *cont'd*

publication. We invite discourse and other views in our never ending attempt to produce good investment results for you. We try our utmost to be guided by solid logic and not emotion. So if you believe that disciplined approach based upon careful and thoughtful analysis is for you then, *Talk with Us*.

Talk with Us.

Notice

This is the 40th edition of *Perspectives*; that is 10 years of quarterly commentary. Looking back over those ten years of work, we believe we have done a credible job. We certainly didn't get the timing right in every case, but did identify the important trends as well as risks. We hope you feel the same way. Let us know how you think we have done as we start our next ten years.

Also this quarter, we welcome David Grachek as Vice President of Sales and Marketing. David has a wealth of experience with AmSouth, Fifth Third Bank Corp. and Trustco. We are confident that David will help us continue to grow.

Investment Strategy

Equities

We have stated for some time now that the investing environment is one in which the strong are getting stronger and the weak are still weak or fading away. Our strategy has been to invest with the strong and avoid the weak. Thankfully, we have found many excellent companies in which to invest. These companies may be growing because of international exposure, or they have managed themselves well and are able to capitalize on the weakness of their competitors, or perhaps they have carved out protected niches for themselves. Those companies that do not live up to our expectations are replaced.

It is hard to overstate the importance of international exposure for U.S. firms. So many firms, when reporting results, identify their foreign business as being much more robust than their domestic results. This is likely to continue for the foreseeable future. The U.S. is a mature economy, currently only growing slowly, while other areas of the world need and want nearly everything.

Looking at our stock market as a whole belies the differences among the various sectors and companies. Certainly, when fear grips, all stocks get dragged down. However, once logic and perspective return, the strong get even stronger. That is why RCM has been doing better than the market at large and why we remain optimistic about good returns in the future.

During the first half of this year, fear dominated. As we approach the election, uncertainty should give way to increasing clarity. We expect that the results from many companies will continue to be surprisingly strong. Then we believe fear will give way to logic. In the mean time we are picking up some terrific bargains. However, if our assessment of the economy changes and we have to confront a different set of circumstances, we are prepared to act. We have identified a number of steps to take.

Fixed Income

RCM has been keeping commitments to fixed income investments short-term. This allows us to reinvest at higher and higher rates as interest rates rise. We are still staying with relatively short-term maturities, because we feel that rates are likely to continue to rise.

Quality is still important, especially since the economy is under more stress. We regularly review the outlook for the fixed income securities we hold. It is important that principal is paid back when due along with the interest earned.



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