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Elephants in the Room

by Paul Woods

For investors, 2007 was a lot of things, but boring wasn't one of them. Conventional wisdom was a casualty as expensive stocks got more expensive, cheap stocks got cheaper, big got bigger, and small got smaller. To make it even more interesting, investors had to white knuckle their way through two 10% corrections in stock prices as the stock market grappled to deal with the meltdown in sub prime lending and its resulting impact on real estate prices and consumer spending.

Unfortunately, the national elections in 2008 reduce the likelihood these problems will get better anytime soon. In an election year, both parties are likely to try to outbid each other to throw as much money as possible at any group that looks as though they could use some help. Among other things, this will probably translate into bailout programs for irresponsible lenders and borrowers that will keep the problems related to sub prime lending festering longer than necessary. Of course, all this government compassion will have to be paid for, and the likelihood of higher taxes after the election is one the elephants in the room that investors will have to grapple with in 2008.

On a positive note, the financial markets picked up a seismic shift in 2007. The best performing industry group was alternative energy, and it wasn't even close. Rising energy prices have finally done what numerous government programs were unable to.

Alternative energy is becoming competitive, and 2008 will mark a milestone guaranteed to give oil and auto company executives the night sweats. Tesla Motors will begin delivering the first electric vehicle that's fun to drive and visitors to the Beijing Olympics in 2008 will be transported in busses powered by electrons that can be produced from wind and sunshine.

In 2007, company size and investment style determined whether stock market investors made money or lost it. Growth was good, value was bad, and capital flowed out of small companies and into big ones. For reference, here's the stock market segment scorecard for 2007:

	<u>Symbol</u>	<u>12/29/06</u>	<u>12/31/07</u>	<u>% Change</u>
All Cap Growth	RUAZG	2,183.67	2,405.85	10.17%
All Cap	RUAZ	822.13	849.22	3.30%
All Cap Value	RUAZV	3,115.65	3,008.54	-3.44%
Large Cap.				
Growth	RUIZG	553.66	611.94	10.53%
MidCap Growth	RUMZG	884.19	976.95	10.49%
Small Cap. Growth	RUTZG	2,401.66	2,557.61	6.49%
MidCap	RUMZ	990.54	1,031.56	4.14%
Large Cap.	RUIZ	770.08	799.82	3.86%
Large Cap. Value	RUIZV	817.76	796.04	-2.66%
Small Cap.	RUTZ	787.66	766.03	-2.75%
MidCap Value	RUMZV	1,142.90	1,102.63	-3.52%
Microcap	IWC	58.45	52.80	-9.67%
Small Cap. Value	RUTZV	4,354.95	3,855.29	-11.47%
REITs	RMZ	1,090.63	870.64	-20.17%

Source: Thomson One Financial, Thomson Baseline

Within these market segments, it was all about energy, clean and otherwise, as oil prices celebrated the first trading day in 2008 by hitting \$100 per barrel. This increase in oil prices boosted energy stocks and made alternative energy more competitive. On the other side of the coin, financial stocks and REITs were thrown overboard by investors because of the meltdown in sub prime lending and real estate. For reference, here's the stock market index and industry group scorecard for 2007:

	<u>Symbol</u>	<u>12/29/06</u>	<u>12/31/07</u>	<u>% Change</u>
Dow Industrials	INDU	12,463.15	13,264.82	6.43%
Nasdaq				
Composite	COMPQ	2,415.29	2,652.28	9.81%
S&P 500 Index	SPX	1,418.30	1,468.36	3.53%
Russell 3000	RUAZ	822.13	849.22	3.30%
Clean Energy	ECO	182.01	288.21	58.35%
Energy	SPENS	455.53	603.04	32.38%

Utilities	SPUT	186.60	216.11	15.81%
Technology	SPHTI	356.28	411.62	15.54%
Consumer Staples	SPCNS	268.41	299.55	11.60%
Capital Goods	IXI	352.16	392.20	11.37%
Basic Industries	SPIN	322.63	354.35	9.83%
Health Care	HCX	388.74	409.70	5.39%
Biotech	BTK	754.25	786.50	4.28%
Transportation	TRAN	4,560.20	4,570.55	0.23%
Consumer Services	SPCCS	302.92	259.53	-14.32%
Commercial Services	SICSS	200.59	171.71	-14.40%
REITs	RMZ	1,090.63	870.64	-20.17%
Financials	SPFN	495.31	392.08	-20.84%

Source: Thomson One Financial, Thomson Baseline

In the second half of 2007, the Federal Reserve still gave lip service to fighting inflation. However, the Fed was lowering interest rates as the inflation rate was rising, which made it pretty obvious that trying to cushion the problems in lending and real estate had become the Fed's the top priority. Keep in mind that the inflation rate for consumers as of November 2007 was 4.31% and rising, while inflation at the producer level is significantly worse. As a result, at present, no Treasury bond has a yield high enough to protect the purchasing power of consumers.

<u>Current Yield</u>	<u>12/29/06</u>	<u>12/31/07</u>	<u>% Change</u>
90 day Treasury Bills	5.02%	3.36%	-33.07%
5 Year Treasury Notes	4.70%	3.45%	-26.60%
10 Year Treasury Notes	4.71%	4.04%	-14.23%

Source: Bloomberg LP

In an election year, our hunch is that political considerations will trump everything else. As a result, we wouldn't be surprised to see further interest rate reductions from the Fed. Even though interest rates are low, the yield curve is still inverted on the short end and there appears to be room for another interest rate cut or two. The flight to quality in 2007 in the fixed income market had the effect of widening yield spreads between Treasuries and everything else. At present, we find the most attractive combination of quality and yield in Government Agency bonds. As yields have come down, we also think it's time to begin shortening maturities, and currently consider 3 year Agency bonds to be the most attractive.

Given the uninspiring selection of Presidential candidates in both parties, it may be more than a coincidence that 2008 is the Chinese year of the rat. However, as we enter it, we find a room crowded with elephants that are becoming more and more difficult to ignore.

The first elephant is increasing inflation. As usual, some government fingerprints can be found. In addition to rising energy prices, poorly thought out incentives to turn food into fuel have produced a glut of unwanted ethanol. While this has had no impact on energy prices, it has produced higher grain prices and this is contributing significantly to the spike in food prices and inflation. As much of this problem is related to an insatiable demand for commodities from an increasingly wealthy third world, inflation doesn't appear to be a problem that will go away anytime soon.

The second elephant is the pressure on consumer spending, which drives the majority of economic growth.

Declining real estate prices make consumers feel less wealthy and less inclined to spend, and election year bailouts for lenders and borrowers will keep the problem festering longer than necessary. In addition, an increasing share of consumer income is being consumed by higher energy and food prices. Leading economic indicators are pointing to a further slowing in economic growth in 2008 as a result.

The third elephant is potentially the biggest and has to do with the sunset provisions on tax cuts. Unless these are extended, most will expire in 2010. For investors, this will mean higher taxes on capital gains and dividends, which will provide an incentive to sell stocks before these rates go up. For consumer spending that's already under pressure, having to send a larger portion of the paycheck to Uncle Sam could be the third strike that produces a recession. Our guess is that taxes are currently as low as they're ever going to be, and the increases could easily happen before 2010.

With all these elephants stomping around, the question is how to avoid getting stepped on in 2008. Because of foreclosures and the inability to make loan payments, there's too much real estate for sale and it's hard to see prices going up. In 2008, we'd classify this as an area to avoid.

Even though it's a challenge to find a quality bond with a yield that matches the inflation rate, the safety of bonds should have appeal for risk-averse investors. If the Federal Reserve follows its usual pattern of waiting until an election is over to fight inflation with higher interest rates, bond investors should find 2008 a safe, but unexciting place.

For stock investors, there are the usual cross currents. The aftermath of the election could be taxes on domestic oil companies rising faster than their profits, drug companies having to reduce prices, and consumer spending under more pressure from rising taxes. At the same time, there are more than a few opportunities. Alternative energy appears poised to become the next big thing, companies that provide what China needs to become the next economic superpower should continue to do well, and there is no shortage of foreign

stocks if the U.S. becomes less attractive for investors. Stocks continue to look undervalued, but stock selection will probably be the key to success in the year of the rat.

As usual, please feel free to contact us if you have any questions or if we can be of any service.

Best regards,

Paul A. Woods
President & CEO

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