



Seeking a return to Normal

CHOPPY MARKETS ENDED MIXED IN JULY, with the S&P 500 down and the Dow Jones Industrial

average up slightly. The tech heavy Nasdaq Composite managed a 1.4% advance for the month, while the Europe, Australia, Far East (EAFE) Index shed 3.2% in dollar terms (2% in local currencies).

Heightened volatility continued as uncertainty remains. Unemployment reached over 5% and global growth is weak. Yet, we see signs of positive change for the overall economy. From a period of dangerous extremes we are encouraged to see valuations returning toward more normal ranges. After spiking dramatically, energy and commodity prices declined as high prices finally impacted demand. The price of oil has fallen nearly 15%, yet is still almost 60% above a year ago. And, although oil receded from its mid-July record high of \$147 a barrel, it continues to pressure world economies.

A year into the credit crisis, financials have been decimated and banks have failed. Real estate prices in most areas are sharply lower. Investors question whether the worst is over, yet some see financial services companies as undervalued.

Several recent trends reversed in July and recent laggards soared. The previously untouchable financial sector popped with a major move up in the second half of July, sparked by better than expected earnings reports (mostly losses that weren't as bad as expected).

Health Care was the single best-performing sector in July and biotech funds surged. Consumer staples, transportation and housing were all strong. Small company funds bounced and outperformed large, and value funds outperformed growth in July.

Many of the funds with the highest 12-month returns were the worst performers last month. Previously hot energy and natural resources funds tanked and gold sank. Energy stocks fell in sympathy with oil, and in fact fell further. Most widely held energy companies, however, trade at valuations below the broader market, and their earnings may actually benefit from a pullback in oil prices.

Emerging markets funds, the top category for the 12-month period, was the worst for July, largely because their economies are closely linked to commodities. Many diversified emerging markets funds sank into the red this month after years of leading performance.

Dollar Shows Signs of Strengthening

Overseas markets lagged our own in July, with Latin America the hardest hit. International funds delivered lower returns in July partly because of a stronger US dollar. The dollar gained about 1% against the Euro in July, but is still down sharply over the past several years.

Is the worst over?

From the highs last October the broad market S&P 500 (with dividends) dropped 21.2% to its low point on July 15. The technical definition of a bear market is a 20% drop off the high. History tells us that "bear" market declines of 20% typically occur once every three years, and last on average, 12 months. But of course market action does not follow a pattern. There is simply no way to know for certain where the market is headed. Stocks could fall further.

We believe we're closer to the bottom than the top, and, we know that the more profitable course is to buy stock funds when the market is down, not sell them.

Predicting the market is less reliable than simply follow it.

While Upgrading has performed well over full market cycles and through good markets and bad, the excellent long-term record is comprised of many ups and downs. Stocks and the funds that invest in them are inherently volatile over the short-term. Upgrading, when measured monthly, only reflects the gains and losses of the funds we hold. The paradox of Upgrading is that it involves focusing on current performance and acting near term, but it is the cumulative effect of these actions that determines our long-term success.

In these stressful times we have to relax and breathe. The strategy will identify the best performing funds thus making the upgrading strategy successful over time!

Thanks again for your trust and continued support,

P. Michael Valley II