CUTLER INVESTMENT GROUP LLC

EQUITY MARKET UPDATE

First Quarter 2008

There have been three major stimuli that have guided investor returns in the past several years: tax cuts, overseas growth, and prolonged periods of record low interest rates. These three variables had created a perfect storm that has led to returns of over 80% from the market trough of 2002. Over this past year, the reversal of one of these three legs of the economic stool, interest rates, created volatility unseen in recent years. As the repercussions of higher interest rates reverberated through the housing and credit markets, equities struggled to maintain their momentum. This was most pronounced in the financial sector, which finished the year down 20%. Financials are the most important sector of the US economy, with the largest share of the S&P 500 at 17.5%. Despite this substantial headwind, equities managed to hold on to gains for the full year period. The S&P 500 Total Return index finished the year with a respectable, if not unremarkable, 5.5% gain. With a dividend yield near 2%, this means the price of listed securities finished up only 3.5% on the year.

It is important to realize that two-legs of the economic stool remain intact as we begin 2008. We will closely monitor the political election this year, as tax cuts have become a political issue. Our assessment of the impact from the Presidential election will wait until the primary process has concluded. The third leg, global economic growth, has rapidly become the most important factor driving stock market returns and remains robust. The past year marked the first time that profits derived overseas have exceeded domestic profits for the S&P 500. This is an historic development, and truly reflects the increased interconnectedness of the world's economies.

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Looking forward, the S&P 500 is trading at roughly 16 times earnings. This is not an expensive valuation, and implies limited risk to investing in stocks. Investors typically have three asset choices to choose from, which include equities, bonds, and real estate. Given the current market conditions, equities appear to be the most attractively valued. Further earnings deterioration is the biggest risk to the equity markets, a result of slowing economic growth. However, we believe a possible recession will be mild in nature, given the Fed's recent aggressive action (see related article), the anticipated stimulus from the Federal Government, and the increased demand for US good stemming from a weaker dollar. Dollar weakness forces higher interest rates in the long-term, but is a boon for US exporters in the near term. (In 2007, exports increase domestically about 14%.) Large, diversified companies are particularly well-positioned to benefit in this environment, and we believe the current year will continue the recent outperformance of high quality companies.

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[IT'S NOT SUCH A BIG WORLD WHEN YOU LOOK AT IT OUR WAY]

Fixed Income Update

A year ago, it was fairly clear that 2007 would be a transition year. At that time, the market clearly expected the Federal Reserve to ease, most likely in the third quarter. This would come as a result of a slowdown in housing, and ease in inflationary fears, and slowing economic data. While the Federal Reserve did end up easing in 2007 and housing did continue to slow, both as expected, 2007 did not play out as expected. It was, instead, a year of market shocks which shut down some markets, sent investors worldwide scrambling, and presented the greatest financial and market crisis in the US since the 1987 stock market crash. Although the first six months of 2007 was relatively mild for the fixed income markets, the eruption that would follow was already brewing. The meltdown in the sub-prime mortgage market led to a massive flight-to-quality in the debt markets. There was a mass exodus in all credit debt into the US Treasury market. This sector had a total return in 2007 of 9.01% while all other sectors lagged considerably. The worst performing sector was the Asset Backed Securities market with returns of 2.21%. The Corporate sector posted returns of 4.56%. At the start of 2007, the Treasury yield curve began slightly inverted as the 3 Month Treasury Bill (5.03%) yielded more than the 30 year Treasury Bond (4.78%). Due to the Federal Reserve's reduction in the Federal Funds rate from 5.25% to 4.25%, the Treasury yield curve became positively sloped throughout the year. The result was 3 Month Treasury Bill at 3.23% and a 30 Year Treasury at 4.45% on 12/31/2007.

Virtually all of the issues and events of the second half of 2007 will remain through much of 2008. Publicity surrounding the housing mess will likely grow as the delinquencies and foreclosures of the past months accelerate. Real estate depreciation and defaults which struck mostly sub-prime loans in 2007 will likely continue to spread and may affect other loan types. This will continue to produce credit pressures in real estate backed securities. However, economic activity and inflation will most likely change. With the expectation of a major slowdown in the economy, it is very likely that the Federal Reserve will continue to reduce the Federal Funds rate. It is difficult to see a rise in interest rates any time real soon, and a return to a very steep yield curve is most likely. This translates into opportunities within the 6-8 year sector of the yield curve as longer maturities provide more income than shorter securities and a roll down the yield curve forces an appreciation of price. Another attractive sector will be the US Agency sector as yield spreads are very wide and credit concerns are almost non-existent. One thing is certain, after several quiet and dull years, the years 2007 and 2008 will serve as a reminder that volatility still exists in the fixed income markets.

Equity Markets Continued...

Despite recent weakness in the equity markets, we are targeting positive equity returns for 2008. Favorable prices relative to other assets, strong overseas growth, and easing interest rates create an environment that has historically been good for equities. Recent volatility is evidence of investor uncertainty, but long-term investors have been well-rewarded in the past for weathering turbulent periods in the markets.

Get out the vote!

Proxies Matter

While voter turnout will be a topic of great interest in 2008, we would like to take a moment to address the importance of shareholder voting. At Cutler, we take our proxy voting responsibility very seriously. Proxies are votes on annual proposals put forth by public companies and their shareholders. They hold substantial economic value, in that shareholders, who own the company, provide an endorsement or a reprimand for management performance. We believe strongly that all votes should be cast in the best interests of long-term shareholders, and our proxy voting policies reflect this philosophy. All clients are able to request our proxy voting policy and a record of past proxy votes (call Carol Fischer in our office for more information).

Proxies and corporate governance are intrinsically related. Shareholders have the responsibility to approve the company auditor and selected directors on an annual basis. Companies provide their financial performance, executive compensation, and share price performance in order to provide greater detail for an educated assessment of the company and management. Currently, Congress is reviewing proposals that would require a non-binding vote on executive compensation. While this is largely a window-dressing regulation, it is believed that greater shareholder scrutiny will reign in CEO salaries. This idea has some merit, as European companies generally have lower CEO salaries, and an advisory proxy vote is required to approve compensation.

Proxy votes are often pre-ordained; after all, one could just sell the stock if management was incompetent. However, occasionally, interesting proxy battles arise. One currently relevant to many Cutler clients is a proxy battle at National Fuel Gas. A Texas-based hedge fund has purchased a 10% stake in the company, and is proposing to replace the company's three director nominees with their slate of directors. Notably, the hedge fund has many specific proposals that they would like to implement in order to enhance shareholder value. However, as long-term investors in the company, we are looking for strategies that enhance value over time. This leads us to assess the company's success at implementing its current strategy. NFG has outperformed both the S&P 500 and its peers substantially over the past 1-, 3-, 5-, and 10-year time periods. This implies that management is competent, and their ability to weather multiple cycles shows strong long-term performance. In this case, we are inclined to conclude that the hedge fund is looking to capitalize on NFG's relatively small market capitalization to sell assets and "turn a quick profit." Therefore, we will likely side with management and, without a change in current fundamentals, will look to hold a company that has increased its dividend every year for 36 consecutive years.

Global Markets and The Weak Dollar

The U.S. dollar, despite its safe haven status, continued its steady decline against most developed and emerging market currencies during the quarter aided by expectations that the Fed will continue to cut interest rates and speculation that the Gulf states may de-peg their currencies. The European euro, British pound, and Japanese yen appreciated 10.9%, 1.7%, and 6.7%, respectively, against the greenback for the calendar year in 2007. Increased risk aversion and de-leveraging pushed the yen 2.9% higher to ¥112.35 for the quarter, and, since the New Year, the yen has continued to gain strength. Demand for their vast natural resources pushed the Canadian, Australian, Norwegian, and Brazilian currencies higher for the year relative to the greenback by 17.9%, 11.4%, 14.7%, and 20.0%, respectively.

In local currency terms, the best performing developed and developing equity markets for 2007 were Hong Kong and Peru advancing 41.6% and 90.4%, respectively. If the U.S. currency is factored, Finland topped the developed market list. Ireland was the worst developed equity market for 2007 losing 20.1% given its heavy index weighting to financials. Surprisingly, most emerging equity markets continued their strong runs in the fourth quarter with the BRIC's alone advancing 9.4% in dollar terms, and some overly-optimistic economists arguing that their economies have decoupled from developed markets and can continue to grow despite a slowdown in developed regions.

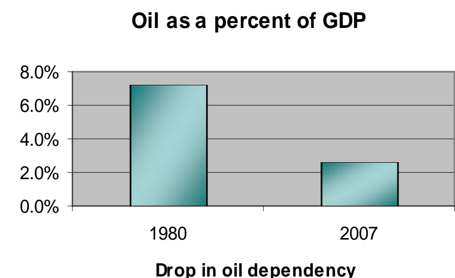
While global markets continue to have attractive growth rates, valuations in many regions are stretched and we favor North American equities on a fundamental basis. Recent market jitters have shown that the world is still levered to US economic growth and the investment snippet "when the US sneezes, the rest of the world catches a cold" may still hold true in the current cycle.

Oil Hits $100

What's next?

In April of 1980 the price of oil hit $102. (It only hit $40, but this represents $102 in 2007 prices!). On January 2, 2008, we rang in the new year with a return to the historic inflation adjusted price when a trade was executed at $100. This $100 trade was largely symbolic, as it was executed by a rogue trader looking for 15 minutes of fame (he ended up losing $600 on the trade, as he quickly sold the $100 position). However, oil had been trading perilously close to the $100 level for some time. While we have been commenting on the rise of oil prices for several years now, this new benchmark may be an appropriate place to reflect on what this plateau means for the US economy.

Of course, much has changed in the past 28 years since oils' last peak. Back in 1980, Americans on average spent 6% of their disposable income on gasoline. Today, that same figure is 4%. Similarly, oil as a percentage of GDP has dropped from 7.2% to 2.6%. This drop in oil dependency largely explains the economy's resilience in the face of these higher oil prices. Nevertheless, the question for investors is at what level will oil begin to drag on economic growth? An interesting possibility is that we may not find out the answer to that question in the current cycle.



Currently, the US is showing signs of economic slowdown. Inevitably, this slowdown will trickle through to commodity prices and the climbing price of oil may take a long-awaited respite. This scenario would have a dual benefit of reducing inflation, as well as acting as an economic stimulus, and the economy would soon recover (and thus oil demand would quickly return). Another plausible scenario, however, is that overseas growth and a weaker US dollar have been the primary determinants of oil prices. In this case, a damper in domestic demand may not impact the price of oil material, and prices will remain high. While we believe this is highly probable, the likelihood is that oil prices will abate from these levels. The long-term trend of oil has been bullish, and the bullish case remains in place. However, speculators who have been increasingly important in oil markets will be hypersensitive to any economic weakness, and we believe a temporary consolidation in oil prices is the most probable scenario.

Fed Policy making headlines: Is this a good thing?

On January 22nd, the Fed acted aggressively to contain the credit crunch fallout with a 75 basis point cut. This was the largest cut at one time since 1984 and market reaction has been positive to the move. While rate cuts are not a "free lunch," they do generally help the economy. The question for investors is where will the cuts help most?

Fed rate cuts typically impact the economy 6-12 months after initially announced. This implies that the current stock market volatility is not reflecting the changes in Fed policy over the second half of 2007.

In addition, the Fed is continuing to cut and the market is currently forecasting at least an additional .50% off the current 3.5% rate before May.

We believe that the Fed policy cycle is bullish for the second half of 2008, and therefore equities will be the primary beneficiary of this monetary easing. Stock prices quickly reflect a change in the economy's momentum, and in our view represent the best place for investment funds at this time.

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