Godsey & Gibb Associates
Investment Watch
June 21, 2007

Housing Remains an Economic Drag but the Portfolio Strategy Impacts Are Manageable

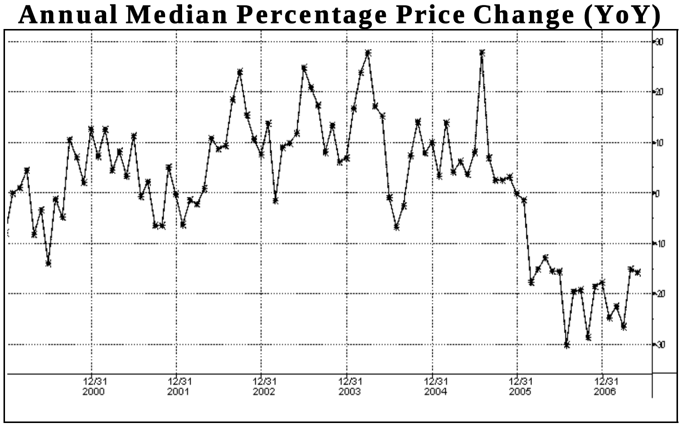
After driving economic growth since 2001, the residential real estate market's contribution to the overall economy has deteriorated over the last year and a half. Although news of the decline in the housing sector is nothing new, we believe the magnitude of the weakness, and its negative contribution to overall economic growth are worthy of further commentary and analysis. Overall, the housing market comprises 23 percent of the economy, when taking into account purchases of furniture, appliances and other household items, according to the Joint Center for Housing Studies at Harvard University. As such, the impact on overall economic growth can be significant. Declines in residential investment have subtracted approximately one percent from the rate of real gross domestic product (GDP) over each of the past four quarters in the U.S.

What sparked the slowdown?

As best we can tell, housing is and will forever be a cyclical sector of the economy, dependant on overall economic growth, job creation, wages, income and fluctuating market interest rates. After a number of peak years, a recent wave of delinquencies and foreclosures has negatively impacted the housing sector.

The subprime sector of the industry has unequivocally been hit the hardest. According to data acquired by Bloomberg, since the beginning of 2006, more than 50 U.S. mortgage companies have put themselves up for sale, closed or declared bankruptcy.

U.S. New One Family Houses Sold
Annual Median Percentage Price Change (YoY)



Source: U.S. Census Bureau, Bloomberg

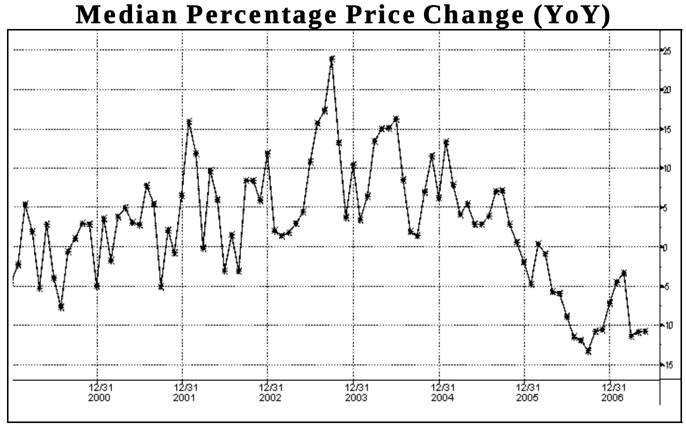
The subprime market caters to borrowers with poor credit or heavy debt loads. In our view, an aggressive push by a large number of independent mortgage brokers and lenders to force subprime loans as much as possible exacerbated the deterioration of the housing sector. Unfortunately, it appears borrowers were often times unaware of the risks, terms and total costs of the loans, leading to a dramatic increase in delinquencies.

While independent brokers account for approximately half of all mortgage originations, they are responsible for nearly 70 percent of all subprime loans. California appears to have been a hot bed of this activity. The state accounts for approximately 40 percent of subprime borrowing nationwide. Moreover, half of the nation's 20 biggest U.S. subprime lenders are California-based.

Wall Street firms appear to be a part of the problem as well. As reported in The Wall Street Journal, investment banking firms have created more than $1.8 trillion in securities backed by subprime mortgages over the last six years. Increased delinquencies push down the value of the securities backed by subprime loans.

Increases in long-term interest rates over the last several years are also influencing both prime and subprime lenders. Borrowers with adjustable-rate and interest-only loans are facing higher rate resets. Higher rates on home-equity lines of credit and home-equity loans have also added financial strain to the market.

U.S. Existing Home Sales
Median Percentage Price Change (YoY)



Source: National Assoc. of Realtors, Bloomberg

Godsey & Gibb Associates • 6802 Paragon Place, Suite 201 • Richmond, Virginia 23230 • (804)-285-7333 • www.godseyandgibb.com

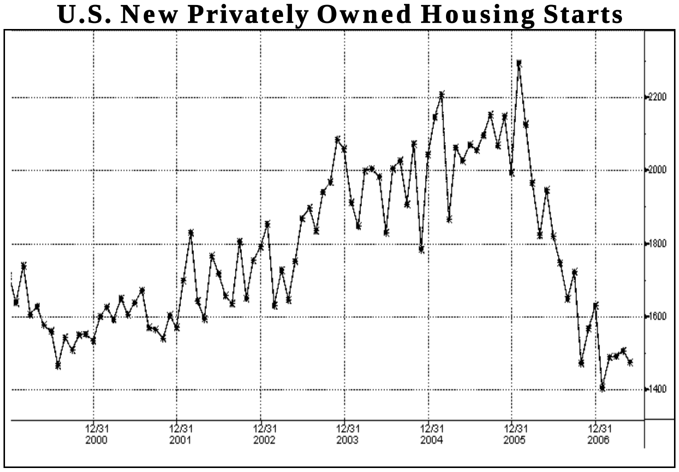
Impacts of the housing slowdown

During the housing boom, demand for property rose, interest rates fell and lenders readily allowed borrowing for many uses. According to a recent paper by former Federal Reserve Chairman Alan Greenspan and Fed economist James Kennedy, home-equity lines of credit generated as much as $187 billion in cash per year between 2001 and 2005. Homeowners used these monies to either pay off other debts or for new spending. In the first quarter of 2007, the "home equity extraction", the amount of money homeowners borrow against the equity in their homes, fell to a five-year low. Greenspan and Kennedy estimate home equity extraction net of fees fell 8 percent to approximately $450 billion, from $830 billion at the beginning of 2005.

Homeowners can extract equity from their homes in multiple ways, including selling at a capital gain, taking out h0me-equity loans, or refinancing a mortgage and taking cash out in the process. The levels of these extractions increased with rising home prices and falling mortgage interest rates earlier this decade. However, a cooling housing market and higher interest rates have made homeowners more reluctant to extract the equity built up in their residences. This can and has led to a reduced level of spending in some markets for both building materials and home electronics. Additionally, mortgage applications and refinancing activity have decreased. As a result, the National Association of Realtors is predicting a one percent drop nationally for existing home prices in 2007, the first decrease since it started tracking prices.

Fortunately the weakness appears to be contained within the housing sector, as late payments for credit cards and auto loans remain near traditional levels. If this weakness were to spread or persist, we would expect the Federal Reserve's Federal Open Market Committee to respond with a stimulative cut in the discount rate.

U.S. New Privately Owned Housing Starts



Source: U.S. Department of Commerce, Bloomberg

Portfolio strategies for the weaker housing cycle

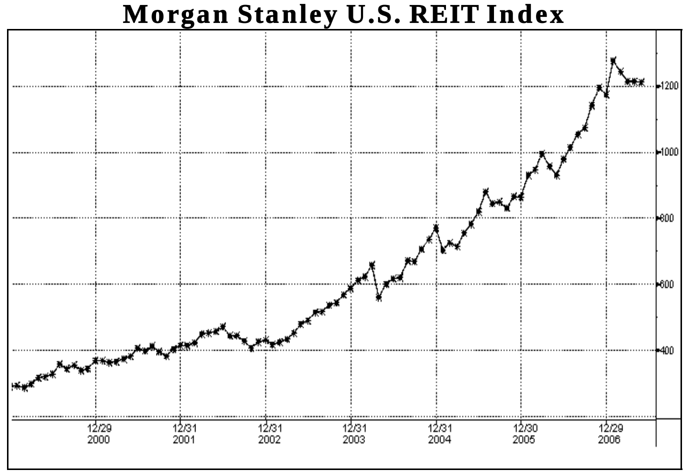
In our efforts to avoid the risks of the weak housing cycle, preserve capital and grow assets over the long-term, Godsey & Gibb Associates has executed on several portfolio strategies:

1. Avoidance of homebuilder stocks: Profits in the sector are evaporating and many of the stocks in this industry are making 52-week lows. Several factors will continue to weigh on the names in our view, including the tightening of sub-prime lending standards, which reduce the number of qualified buyers, and gradually higher interest rates, which dampen demand at the margin. Residential home construction is set to register another quarterly decline this quarter as well.

2. Remove exposure to real estate investment trusts (REITs): Residential weakness impacts commercial real estate and after huge price run-ups, the average yield on REIT stocks has fallen from over 6% to just over 3.7%. After outpacing the broad market for years, the fundamentals indicate that these securities are over valued. The Vanguard REIT Index Fund, which attempts to replicate the Morgan Stanley REIT Index, was recently trading at 43 times its underlying earnings, as compared to 18 times for the S&P 500 Index.

3. Structure high quality fixed income and equity portfolios without exposure to subprime lenders and collaterized debt obligations (CDOs): CDOs are structured debt securities backed by a portfolio of bonds, including mortgage loans, and derivatives. Higher quality U.S. Treasury and Agency notes, along with highly rated corporate notes, provide far greater principal protection and attractive income generation potential. Moreover, after multiple years of leadership from value stocks, large cap core growth stocks appear to be attractively valued relative to the underlying earnings growth rates.

Morgan Stanley U.S. REIT Index



Source: Morgan Stanley, Bloomberg