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Interim Report to Investors – Close of the 1st Quarter, 2007
With General Commentary on the state of the US Real Estate Market

Sunday, April 15, 2007

To our friends and investors:

What an interesting quarter this has been! Recent stock market movement has been substantially more volatile than any period over the past 2 years, the Iranians alarmed world energy markets by taking British soldiers hostage, and the housing market showed signs that the worst isn't yet behind us. Also this quarter marked a subtle shift in strategy for many of my more conservative accounts. Partly because of this rare strategy change I chose to issue an interim report at this time.

As you may recall, it has been about 9 months since I issued my last report. At that time the markets were heavily selling off and many market pundits were pronouncing the end of the bull market. I sent out a very strongly worded report emphasizing that stock market fundamentals were extremely favorable and to "keep the course" with large cap stocks; the market then went on to yield some of the best returns in recent history. Now, due to increasing imbalances in the world markets and the potential for significant fallout from the US real estate market, I am growing a little more cautious, even while I still maintain a bullish long-term view on the world equity markets.

This long-term bullishness is why the change of strategy has only occurred in some accounts. The closer you are to retirement and the more averse you are to risk the more likely your portfolio recently underwent increased position changes. Those of you who can withstand heightened volatility and relative risk have seen more moderate to no change in your portfolios because of the opportunity for long-term returns and my (and I argue everyone else's) inability to accurately predict short-term market movement with any degree of certainty. I will emphasize in this report the "bad" news facing the economy, although there is certainly more than enough "good" news to talk about.

The most overt and immediate risk to the US economy is the real estate market.

"The most notable risks [to the world economy include] the U.S. housing market could cool more rapidly than expected, triggering a more abrupt slowdown of the U.S. economy."

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– ***The international Monetary Fund ("IMF")*** *World Economic Outlook, September, 2006*

My chief concern for some time has been the real estate market and the potential spillover effect it may have on the larger economy. I believe there is a chance we *could* suffer a further significant decrease in real estate prices in the next 12 months. The risk is high enough and the consequences dire enough that I have begun to lower the exposure of some of our portfolios to equities. The principal reason to heighten our cautiousness at this conjecture is a once theoretical catalyst for accelerated real estate depreciation is closer to becoming reality: the implosion of the sub-prime mortgage market. We shall elaborate more on that later in this report.

Why is Real Estate Risky and Why is it Dangerous to the Overall Economy?

Let's start with how assets are valued. The real estate markets, like any other free market, have prices that are determined by supply and demand. There are several variables that influence supply and demand in the housing market demand. The most pertinent demand variables include:

Real economic growth

The US Economy has shown remarkable resilience over the years to overcome adversities and grow; I doubt this phenomenon will change. Higher wealth almost always portends greater real estate investments and valuations. So, one may say, this is a bullish argument for real estate investment? Not exactly.

The challenge for the real estate market isn't the long term direction of the US economy; it is that valuations have far outpaced most fundamental economic underpinnings, not the least of which is affordability. It is my belief that real estate is still fundamentally overvalued and there are two potential outcomes: the economy must catch up to prices over time ("soft landing") or prices must come down (potential "hard landing"). A "hard landing" would likely precipitate a recession.

Supply of money

Interest Rates

Recently the US consumer has experienced an increase in buying power because of accommodative fiscal policy (very low interest rates). The Federal Reserve recently cut short-term interest rates to historic lows, partly to counteract the effects of the imploding of the last investment bubble (technology stocks).

Lower interest rates affect the real estate market by lowering payments for any given loan amount, which amplifies effective purchasing power. Homes are usually purchased based on monthly payment with little concern given to the overall price. Unfortunately rates have been increasing recently, which is having the opposite effect (increasing payments and decreasing affordability).

The lowered interest rates and increased valuations also meant that homeowners could take cash out while keeping their payments low; which, in turn, encouraged homeowners to take on greater levels of debt. Much of that debt was used to purchase more property, further inflating the housing market. Consumers also took money out of their homes for other purchases, which supported economic growth. But now rates are increasing and properties are depreciating.

As rates increase (especially on adjustable loans and home equity loans) consumers shall have less money to spend elsewhere; this will lead to less economic growth. Additionally speculators who purchased negative cash flow investment property with hopes of ever ascending values are finding themselves having make increasing payments on properties that achieve even greater levels of negative cash flow. It is my belief that cash flow is the most fundamental element that makes investments truly investment-worthy. Whenever an investment is burning cash (be it called real estate, stocks, or otherwise) it is likely to be sold from our managed portfolios.

Increased credit availability / The Sub-prime Factor

"We [the mortgage industry] are all going to be struggling; struggling more than we are today. We're headed half way down the mountain, and we've got a ways to go."

Robert A. Camerota, Sr. Chairman of the California Mortgage Bankers Association March 3, 2007 as reported in the *North County Times*.

Recent low interest rates were accompanied by an increase in sub prime and creative lending programs. This permitted more consumers with less-than-stellar credit (and little to no savings) to qualify for mortgages and it enabled those with good credit to leverage more than otherwise would have been possible. This further increased the pool of buyers and amplified the surge in demand for real property.

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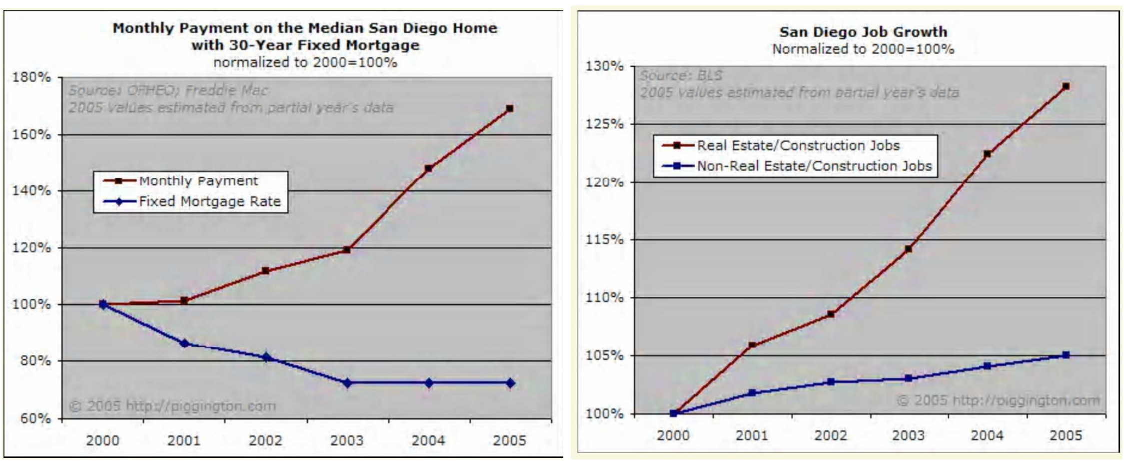
We are starting to see a sharp reversal of funding of these high risk loans which is removing a significant source of demand from the market. Additionally the "creative" mortgages are adjusting to higher interest rates and payments which could force many owners to sell just as demand and prices are waning. If homeowners cannot afford their increased payments they may not be able to qualify for a new loan because of tightened credit standards, thus they shall be forced to sell their property or default on their mortgages. This could spell disaster: a sharp increase in supply coupled with fewer buyers could sharply reduce valuations. *The extraordinarily rapid demise of most of the country's sub-prime lenders presents the greatest near-term risk to the overall economy and increases the risk of a "hard landing" (and thus our more defensive posturing).*

"We are only at the very beginning of the problems facing subprime. This liquidity crisis is continuing."

Sanford C. Bernstein & Co. analyst Brad Hintz, March 7, 2007 as reported in *The Wall Street Journal.*



These graphs demonstrate some of the recent imbalances in San Diego real estate (the data is similar in most other areas of the country and are generally worse in areas such as Temecula, CA; Las Vegas, NV; and areas of Colorado). The graph I find most disturbing the one titled "Job Growth." Because real estate employs a larger proportion of our population it indicates a scenario could develop where if real estate performs poorly the local economy may shed jobs which would further depress the overall economy.

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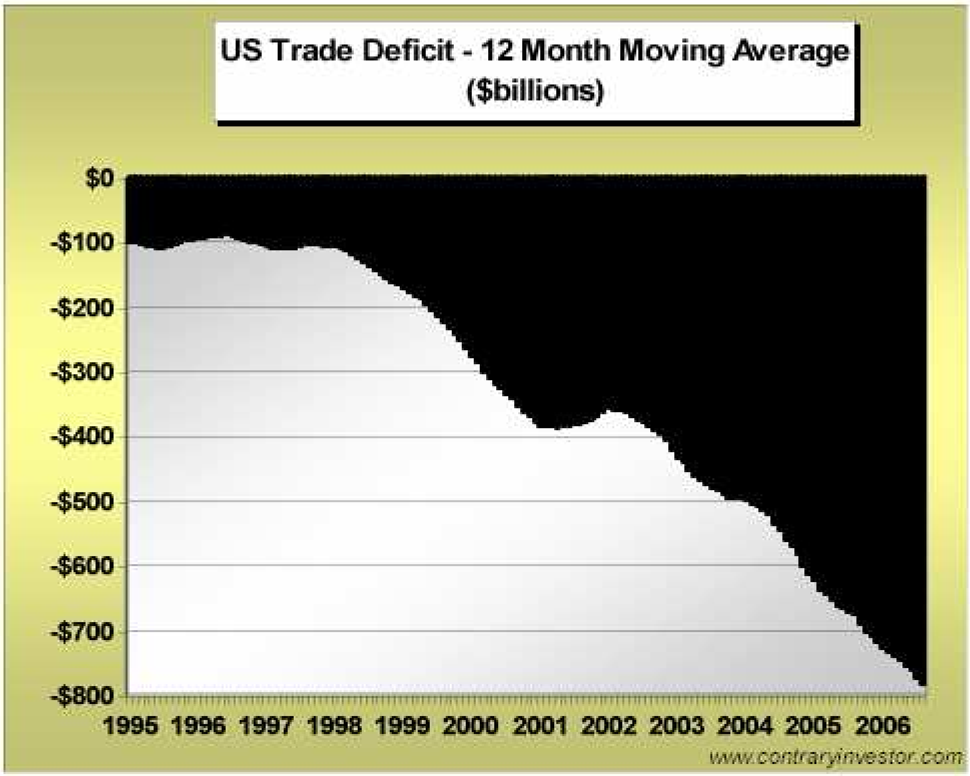

The dangers in the real estate market are accompanied by record trade deficits. This means that if real estate leads the economy into recession the Federal Reserve may have difficulty cutting short term interest rates without battering the dollar and stoking catastrophic inflation.

With the recent shake-up in the sub-prime loan market, the scene is set for a potential further and more precipitous drop in real estate prices. The worst case scenario could be calamitous near-term for the overall economy because lowered home valuations and higher mortgage payments may reverse the recent real estate “wealth effect” (people spending cash from refinanced homes), leading to decreased consumer spending, hindering corporate earnings, causing depressed stock values, leading to a decrease of foreign capital inflows, leading to a decrease in the value of the dollar which would increase inflation and could force the Feds to increase interest rates. An increase in interest rates could then further exacerbate the damage to the housing market and stock markets.

Thus the risks the real estate market poses to the overall economy are real enough for us to have made maneuvers to mitigate some of the risk to our more conservative investors. However even with these allocation changes, most accounts are still heavily invested in stocks (both domestic and foreign). <u>So if there are risks to the market why are the rest of</u>

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us not selling changing strategy, as well? First of all there are *always risks* to the economy, the changes of a hard landing are small and…

The overall state of the world economy appears to be extremely strong.

The efficiencies and wealth being created from open trade, more powerful computing, the rise of emerging markets (both Asian and elsewhere), and wireless and internet communications are substantial and show no signs of ebbing. Barring any fundamental changes (read US protectionism) the stock markets should be an extremely good place to be over the *longer term* (and, barring an unlikely real estate collapse, the short-term as well). Therefore those of our clients with longer-term horizons are still fully invested in equities and shall remain so unless stock valuations outpace their potential for cash flow and earning growth and distribution. Such events rarely occur, with the most recent imbalance correcting itself near the turn of the century.

Even Warren Buffet, despite his disappointment with the mindset of the American consumer, believes in the long-term resilience of the American (and world) economies:

"I want to emphasize that even though our current course is unwise, Americans will live better ten or twenty years from now than they do today."
- Warren Buffett, Chairman of Berkshire Hathaway, February 28, 2007 as quoted in *Berkshire Hathaway's 2006 Annual Report to Shareholders*.

So where are we focusing our investments on now? We still see good values in energy, multinationals, pharmaceuticals and healthcare, and select technology companies.

Our recent mistakes / What could have we done better?

I hardly claim to be impervious to mistakes and my goal is to accept responsibility when they happen. My mistakes of the past quarter were as follows:

Our Speculative Options Positions Performed Poorly

Some of our extremely speculative accounts and one of our non-diversified accounts have not done well. However one must keep in mind that we only *expect* speculative stock options to have a positive return only a fraction of the time; most of the time they shall experience a 100% loss. Fortunately these accounts were small in number (three) and small in size (both nominally [all were under $20,000] and in comparison to the owners' overall net worth). Our hope is over time a few phenomenal winners shall emerge and provide an overall attractive return on our investments.

Seagate Technology (STX): The largest losing stock option and stock for most accounts was Seagate Technology, the world's largest manufacturer of computer hard drives. The company has excellent management, a low value compared to projected earnings, no debt, and significant cash in the bank. There is negative sentiment because it is feared that flash memory shall make hard drives obsolete. It is likely, however, that the worlds demand for data storage shall continue to grow by orders of magnitude and that hard drives shall remain a viable product. My hope was with the release of Windows Vista and with the merger of Maxtor behind Seagate that Wall Street would focus on projected earnings. Even though earnings estimates have generally been rising Wall Street has instead chosen to focus on disappointing news from top computer manufacturers such as Dell Computer. Only time will tell if Seagate flounders or prospers. I shall keep you posted.

Consol Energy (CNX): Probably the worst stock "trade" I made over the past three years. A year ago I was gushing with enthusiasm for the prospects for coal into the foreseeable future (especially high sulfur coal made by Consol). To my chagrin, toward the end of 2006 it appeared that America was poised to be awash in coal supply due to the warmest winter on record and increased production. I then substantially trimmed our positions, accepting losses. To compound the pain, shortly after taking these losses the weather turned much colder, several mines ran into production problems, and then the Iranian hostage crises have all caused a run up in these shares. Fortunately in many accounts the proceeds from the sale of CNX went to fund purchases in other energy companies, such as Valero (VLO), Chevron Texaco (CVX), and Exxon Mobil (XOM) - all which have performed very well.

Our recent successes / What have we done right

Fortunately the vast majority of our assets were positioned to take advantage of the recent market advances. The following are highlights of our recent strategies that have proved profitable:

Overall overweight in stocks: We have been handsomely rewarded for our emphasis on stocks. In actuality our changes in our more conservative portfolios only partially reverses their being fundamentally overweight in stocks (because we saw *extraordinary* value in stocks over the past 5 years). Furthermore, in many accounts we have increased our hedging activities more than we have changed our overall allocation to stocks. These hedges shall help mitigate the effect a more pronounced downturn would have on these portfolios while affording reasonable participation in market rallies.

Overweight in energy: We have been overweight in energy for more than four years and shall continue to be overweight in energy for the foreseeable future. We held on through the hedge-fund-killing energy correction that bottomed in March and are once again riding high. The world's demand for energy is very close to the level that current infrastructure can provide. It is my belief the overall world economy shall remain strong and energy demand shall increase in industrialized nations and continue to skyrocket in China, India, and other developing markets.

Overweight in foreign equities: Because of the USA's large trade imbalance and out reliance on foreign investments I believe the dollar is likely to remain under pressure. We will continue to try to increase our foreign stock holdings. We are also overweight high quality international bonds to further take advantage of any dollar weakness and higher interest rates available in other developed countries. We have significant exposure to Asian and Pacific Rim currencies through several funds, including the Aberdeen Asia Pacific Income Fund (FAX). The US Dollar has been losing value compared with these currencies and fundamentals suggest the dollar may weaken further. Also the world economy as a whole continues to post phenomenal growth (led by Asia): <u>the world economy has perhaps never looked better.</u>

Underweight real estate and real estate debt: As previously mentioned, I have believed and continue to believe that real estate investments, in aggregate, are the most unattractive asset class. Ironically we did find values in several commercial and multifamily real estate investment trusts (REITs) because as Main Street lavished more money on homes Wall Street punished REITs to the extent that many traded below what I calculated the discounted market value of their assets and future cash flows. One closed-end fund that we purchased for more than a 16% discount to net asset value (and sporting a dividend over 7%) was converted into an open-ended fund creating a 16% gain almost overnight. Many accounts also did well when Equity Office Properties was subject to the largest leveraged buyout in history (we benefited from direct ownership in EOP and through the closed-end funds).

<u>Summary / Where do we go from here?</u>

After having been unabashedly bullish on the stock market since the summer of 2002 (first advocating small cap stocks and more recently large cap stocks) we are growing a little more cautious. *I am still very excited about the long-term prospects for the world*

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equity markets; however the near-term risks are high enough to reevaluate some of our positions.

The potential for a disorderly unwinding of global imbalances remains a concern. A Smooth, market-led unwinding of these imbalances is the most likely outcome, although [global] investors would need to continue increasing the share of U.S. assets in their portfolios for many years to allow this to happen. The depth and the sophistication of the U.S. financial markets has facilitated the financing of recent large current account deficits. However there remains some risk of a disorderly adjustment, which could impose heavy costs on the global economy.
IMF World Economic Outlook, Release Date: September 2006

IMF experts still expect solid global growth to continue, forecasting the world economy will grow an impressive 4.9 percent in 2007. I continue to believe world economic growth will trend above baseline for the foreseeable future and that equity markets will continue to post impressive returns over the long-term.

Update on merger:

As most of you know I was recently approached by a much larger company interested in merging my business with theirs; I would then eventually be responsible for managing their portfolio (which currently is about 40 times bigger than my own!). It was tempting; however right before consummating the deal I realized I would have to give up too much: most notably my ability to continue charity work and to help those with less than $1M per year to invest. One of the chief reasons I went into this profession was to help those in need, no matter what their ability to pay; I almost lost sight of that. My minimum investment that I "target" (for profitability) is $250,000, but I will continue to help whomever I can whenever possible.

Therefore please send me your tired, your weary *and* your financially successful for advising and investment managing. Also please keep in mind that through affiliations with different companies I can help ensure you, your friends, and your associates receive advice on insurance and real estate investment and financing (mortgages) at a fair rate and pertinent to an overall financial plan.

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As always I am a phone call away if you would like to discuss this report or any issue specific to your needs or circumstances.

Sincerely Yours,

Mark Daniel Elliott, Registered Investment Advisor (CRD#139796)
President, Elliott Asset Management, Inc.

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