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Mid-Year Investment Review

Your equity portfolios on the whole joined in the second quarter's rally after a bumpy first quarter. Due in part to our overweighting materials and telecom – but mainly due to our underweighting the huge financial sector (see box at right) – in the aggregate we outperformed the S&P 500 by 2.3% for the first half. Your bond portfolios have kept their footing against a backdrop of rising yields (which means falling prices) as the term structure of interest rates has normalized to an upward slope (which means longer maturities again are bringing higher yields after a long inversion); outperformance came from our overweighting the short end of the yield curve, where prices are less sensitive to yield changes, and keeping a strong bias toward quality.

Total Return Jan-Jun 2007	
Allen Trust Equities	9.27%
S&P 500	6.95%
Allen Trust Bonds	1.58%
Lehman Aggregate Bond	0.97%

Note: Performance stated gross of fees.

On this last point of quality, which I've belabored for a while now, we are starting to see major pain in the lower reaches of the credit markets: Bear Stearns has had to pump a few billion dollars into two of its CDO (collateralized debt obligation) hedge funds to save them from liquidation, or more precisely, to bail them out of their illiquidity upon discovering that the market wouldn't buy their assets at anything close to modeled value; S&P and Moody's are moving toward downgrades on nearly \$20 billion in sub-prime mortgage backed securities, while intimating more such to come; and a half dozen new high-yield issues have fallen flat when brought out for bid.

Weakness on the debt side of the capital markets could undermine strength on the equity side, as mergers and acquisition activity has been driving the gaudiest of recent stock gains, and much of that activity is fueled by financial leverage. If junk bond issuance suffers, so may M&A; if M&A suffers, so may the broader stock market.

Gloomy stuff to contemplate, but in the short run

there's another possibility. "Meltdown" is a workaday term, handy for describing anything from your favorite team's blowing a huge lead to a toddler's descent into rage to, of course, a market's collapse. But have you pondered the notion of a "melt-up"?

S&P 500 Sector	YTD 2007	Weight
Energy	16.3%	10.8%
Materials	15.5%	3.1%
Industrials	9.9%	11.1%
Consumer Discretionary	2.4%	10.2%
Consumer Staples	3.7%	9.3%
Health Care	5.2%	11.8%
Financials	-2.0%	20.9%
Information Technology	9.0%	15.5%
Telecommunications	13.6%	3.7%
Utilities	7.2%	3.5%

Source: Standard & Poor's

Some suggest we may be flirting with a "melt-up" phase for stocks: a transition toward unreason where bad news gets ignored, marginally good news gets hyped, and "no news" gets interpreted as yet another reason to buy. It can be a lucrative time to own equities, but a hazardous one as well, as melt-ups tend to resolve into their more familiar antonym.

Riding a melt-up and surviving with your gains in pocket demands a well-timed exit via a "bigger fool" counterparty to your liquidating transactions. We have a problem with this in two regards: 1) timing the exit right is devilishly hard (not to mention expensive, tax-wise), and expecting to do it consistently right is the worst sort of hubris; 2) relying on the simultaneous foolishness AND liquidity of others to fund a well-timed exit is a stratagem that we believe just as likely to prove oneself the fool.

So with misgivings about the sustainability of further rallying from this point, what are we to do? First of all, dispense with the notion of timing and instead focus on value: we pursue undervalued assets regardless of market environment, and when finding none, sit on our hands. Practically speaking, this can result in some highly uncomfortable waiting around, but such is the burden of cleaving to discipline. Second, with respect to exiting existing positions: we won't except in those instances where cash is needed or where we believe overvaluation to be significant and liquidation justified on an aftertax basis. Strategic allocations, once implemented, will be adhered to, and this entails holding stocks across peaks and valleys alike.