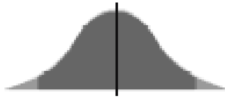

Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON **NICK LEVINSON, CFP®**

JUNE 2007 COMMENTS

THE CURRENT STOCK MARKET AND YOUR ASSET ALLOCATION:
In our May 2007 Comments we wrote: "At the end of July 2006, the S&P 500 index stood at 1,277. Ten months later, at the end of May 2007, this index closed at 1,531. This gain of 20% has brought the S&P 500 index to an all-time high, surpassing the previous high reached over seven years ago (and retracing the almost 50% decline that occurred during the bear market of 2000-02). For additional context, over the 18 months prior to July 2006, this same S&P 500 index had gained less than 10%." As if on cue, the stock market (S&P 500) proceeded to decline 1.9% in June, with the S&P 500 closing at 1,503 (bringing the eleven month gain to 17.7%). We think the points we made last month on this subject are worth repeating again:

1) These gains may or may not continue; the future, as always, is unpredictable. (Reference Nick Taleb's new book, "The Black Swan", for much more on this subject. We will be discussing the ideas in this book extensively in future Comments);
2) Whatever appropriate asset allocation you had last summer, assuming your goals and your risk tolerance have not changed significantly, remains appropriate now, subject to the idea of rebalancing (see below);
3) Rebalancing refers to the idea of selling some of the higher-performing asset class, to return the allocation to its prior, appropriate percentage mix. If you have additional funds to invest, rebalancing can also occur by buying more of the lower-performing asset class. In either case, rebalancing is the opposite of buying into the higher-performing asset class as it moves higher and higher.

LONG-TERM CARE INSURANCE (LTCI):
For those of you who do not have LTCI, we suggest you review this subject with us. We believe LTCI is an important part of planning for the conservation of accumulated assets, and deserves your attention.

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Also Years 1999 – 2006, and Various Other Longer Time Periods
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Pages 5-8 Current Issues in the Financial Markets

Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

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COMMENTS: INDEX RESULTS for period ending JUNE 2007

STOCKS	YEAR 1999	YEARS 2000-02	YEARS 2003-05	YEAR 2006	YTD 2007	JUNE 2007
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	7.5%	(1.8)%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	6.0%	(1.9)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	7.9%	(1.4)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	6.7%	(2.3)%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	7.6%	(1.7)%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	7.8%	0.0%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	10.8%	(2.3)%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	9.2%	(1.8)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	11.9%	0.6%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	17.9%	5.0%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	(6.3)%	(9.5)%
BONDS						
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	0.8%	(0.4)%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	0.1%	(0.4)%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	1.9%	0.1%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	1.5%	0.1%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	1.7%	(2.4)%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	1.7%	(0.2)%

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
		1999				**2000**				**2001**		
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3
BONDS Interm. Tax.	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0
		2002				**2003**				**2004**		
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9
BONDS Interm. Tax.	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0
		2005				**2006**				**2007**		
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8		
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5		
BONDS Interm. Tax.	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4	(0.6)		

JUNE 2007 COMMENTS

STOCK index prices for US stocks declined moderately during June, following two months of strong gains. Q2 results for stocks were quite favorable, compared to Q1 (see quarterly chart above). International indexes were positive in June, while the REIT index, the major outperformer for years, posted an almost 10% decline, and is now negative for the year. (See the third paragraph below on this page for additional discussion, and see page 2 above for all figures for the month, YTD, and since 1999).

BOND returns (price change plus interest) declined for the second consecutive month, as prices fell along with a continuing rise in market interest rates. The benchmark 10-year US Treasury yield closed at 5.03%, which was 40 bps higher than April's close, after exceeding the previous 12-month high of 5.25% during the month. The twelve month low of 4.47% is now a distant memory. The current short-term overnight rate set by the Federal Reserve remained at 5.25%. The inverted yield curve that has persisted for most of the past twelve months has also been reversed, although by a quite narrow differential. Bond returns for the month, YTD, and since 1999 are set out on page 2 above.

ECONOMIC NEWS for the month, particularly the recently reported positive employment figures and strong retail sales, pointed to continued growth. Core inflation figures were moderate, but with food and energy prices included, the inflation figures were far higher. The financial markets reacted negatively to instances of problems with various hedge fund investments, and higher interest rates for buyouts (a detailed discussion of the issues currently affecting the markets begins on page 5). Further, it appears that strong economic growth outside of the depressed housing sector has greatly reduced the near-term likelihood of lower interest rates, which on balance is probably a negative for the financial markets (faced with strong economic growth, investors become concerned (rightly or wrongly) that the Federal Reserve will raise rates in order to contain future inflation).

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From a longer-term standpoint, the stock market rally that began decisively in March 2003 now exceeds four years. But the declines of the preceding three years (2000-02) have resulted in price changes (since the highs of 2000), excluding dividends, far below their long term historical averages, with the Dow Jones up 14%, the S&P 500 down (2%) and the NASDAQ down a stunning (48%). In a fascinating observation, the mutual fund company Vanguard notes that from 1926 through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of plus 10.4%.

Since the spectacular 1994-99 bull market began, all three major indexes have remarkably similar average annual returns (ranging from 10.0% to 10.5%) that are almost identical to the 10.4% average annual return of the stock market dating back to 1926. As these returns converge, the idea of "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), comes clearly into focus. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the returns from 2000-YTD 2007 were far lower.

The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, even with (so far) a fairly stable very-long-term average return. Key Questions: Your relevant time frame and tolerance for risk.

	S&P 500 (1)		DOW (1)		NASDAQ (1)	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2006	1,418	(7)%	12,463	+6%	2,415	(52)%
Year-to-date 2007	1,503	(2)%	13,409	+14%	2,603	(48)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

	S&P 500 (1)	DOW (1)	NASDAQ (1)
End 1994	459	3,834	752
End 1999	1,470	11,500	4,070
Gain	1,011	7,666	3,318
Avg.Ann.%Gain:'95-'99; 5 years	26.2%	24.6%	40.2%
JUNE 2007	1,503	13,409	2,603
Gain	1,044	9,575	1,851
Avg.Ann.%Gain:'95-6/07; 12.5 yrs	10.0%	10.5 %	10.5 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

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INVESTMENT CONCEPTS:

Current Issues in the Financial Markets

During June, the financial press was filled with stories that, while on their face appeared unrelated, actually had a number of common underlying themes. This section is our effort to pull these stories together and put them in a more understandable context.

The stories, and their June Headlines (all from the Wall Street Journal ["WSJ"] unless otherwise noted):

1) The rise in longer term interest rates: "Long Term Rate Rise Prompts Strategy Shift" (6/20, D1); "US Bond Yields Hit Five Year High" (6/13, front page, referencing the benchmark 10-year Treasury reaching 5.25%).

2) Blackstone Group's Initial Public Offering, in which CEO Stephen Schwarzman had his stake in the firm valued at $7.7 Billion: "Blackstone's World of Cash" (6/21, A17). (Blackstone is a private equity firm)

3) Bear Stearns hedge funds face shutdown from large losses in the sub-prime mortgage backed securities market: "Two Big Hedge Funds Run by Bear Stearns Face Shutdown" (6/20, front page).

4) Borrowing at attractive rates using Collateralized Loan Obligations (CLOs) provided much of the money for many of the buyouts of the past few years: "Behind Buyout Surge, A Debt Market Booms" (6/26, front page).

The narrative that goes with these stories, all of which have come to the fore this June, goes back to the very low interest rates that the Federal Reserve put into place to counter the economic slowdown that accompanied the bear market in stocks from 2000 to 2002. With money available at low rates, private equity firms borrowed large amounts to make their acquisitions, and home buyers were encouraged to buy more house than they might otherwise be able to afford. The markets for both companies and houses moved upward, based in part on the availability of cheap money. Financial firms of all kinds encouraged these transactions, and prospered from the fees they generated. Over the past few years, the Federal Reserve has raised the short-term interest rates it controls (reaching 5.25% one year ago, a rate which is still in place today), but longer-term rates (measured by the benchmark 10-year US Treasury) have remained quite low. This has resulted in an inverted yield curve, in which short-term rates exceed long-term rates, a situation that we have mentioned consistently in our Monthly Comments. It was these low longer term rates that encouraged the buyers of companies and homes to continue their buying, pushing prices even higher. Now, in the past month or so, these longer term rates have increased to five year highs, and the corporate buyout market is being affected. The home buying market had already been under pressure for a year or so, and these higher interest rates have made that market even more vulnerable. This is particularly true for buyers who had weak credit to begin with, but still took on variable rate mortgages that are now adjusting upwards.

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In short, the current interest rate environment of higher long term rates has had a negative effect on both the corporate and home buying markets, which in turn adversely affects those who have lent money to support the buyers. CLOs and sub-prime mortgages, major financing tools for the buyers, have become suspect, and the private equity firms and hedge fund firms that have prospered by making investments in the low interest rate environment may now become suspect as well.

Reference to the WSJ articles mentioned above, and some other recent articles, highlights these points:

Andy Kessler, writing about Blackstone and the private equity boom (6/21, A17), states that what is fueling the boom in private equity buyouts is that "the world is awash in cash…which leads to distortions from fixed income investors such as banks, insurance companies, pension funds and hedge funds, all chasing higher yields The biggest beneficiary has been private equity funds. They buy companies by putting up some cash and then borrow the rest. Their borrowing costs, which show up in the spread between their rates and 10-year Treasuries, have been at historic lows. Anything less than four percentage points is a gift. It bottomed recently at 2.4%, which is a ridiculously low hurdle to jump over to justify a buyout. Plus Wall Street has created a huge business in credit swaps and derivatives to help more money flow into private equity deals….The dirty little secret is that private equity investors really aren't all that good. They take mediocre investments with lackluster growth but steady cash flow and add leverage to amplify returns…." Kessler also talks about the huge fees that the private equity firms take when doing transactions, which go to the general partners, not the investors in the fund. He concludes that "ten year bond rates now approach 5.25%..., and if the economy slows, debt payments get tougher… Hedge funds will go chase something else. This is the stuff that sours credit cycles."

The article that discusses the use of CLOs (6/26, front page) defines its subject as "giant pools of bank loans bundled together by Wall Street and sold off to investors in slices. They aim to spread default risk an inch deep and a mile wide. Last year more than half the loans behind the record wave of buyouts were parceled out to investors as CLOs. As corporate borrowings soar, concerns are growing that CLOs have made it too easy for shaky or debt laden companies to borrow money. If economic conditions deteriorate, these loans could sour and investors in the riskiest CLO slices could face large losses. That in turn could make it harder for buyout firms to borrow money….The past decade has seen headlong growth in markets for various complex financial products, from derivatives to mortgage backed securities to CLOs. These booming markets are mostly opaque: investment offerings are private and largely unregulated, trading is sometimes thin, and the securities can be hard to value. That makes it especially difficult to predict what will happen if market conditions rapidly turn unfavorable….The market for mortgage backed securities, which are similar to CLOs but backed by home mortgages rather than corporate loans, is providing CLO investors with a case study in how quickly values can tumble. Trouble in the housing markets have driven down the value of securities backed by risky sub-prime mortgages….Two Bear Stearns hedge funds with substantial holdings of illiquid securities backed by sub-prime mortgage bonds had to scramble to stave off collapse after their assets lost much of their value…. The companies behind many of the CLOs aren't the only ones loaded with debt. Many investors who put money into CLOs use borrowed money to magnify their returns."

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(Our note: Think of hedge funds, all looking for an edge to get a higher return for their investors, using borrowed funds to magnify their returns).

The article explains that CLOs are divided into different pieces based on the credit risk involved; the higher risk gets a higher return, which works for the investors unless a significant number of the loans go bad. The banks that arrange the financing do not hold on to these loans, so the underwriting standards for these loans have slipped. Banks collect fees and are encouraged to do the transactions, regardless of the creditworthiness of the borrower. "Banks enable and encourage private equity firms to load up their companies with debt."

Another article, "Lending a Hand: How Wall Street Stoked Mortgage Meltdown" (6/27, front page), emphasizes the relationship between easy credit and high risk loans, and the high fees earned by the intermediary financial firms. "Critics say Wall Street firms helped create the mess by throwing so much money at the market that lenders had a growing incentive to push through shaky loans and mislead borrowers….Wall Street firms provide working capital that allows thousands of mortgage firms to make loans…investment banks pool the income streams from these loans into bonds known as mortgage backed securities, which are then sold to yield hungry investors around the world.…Pooling the loans created a cushion against defaults by diversifying the risk." A chart accompanying the article indicates that fees are paid to: (i) the mortgage broker, with direct access to the client borrower; (ii) the lenders who make the loans, often with funds provided by the investment bank; and (iii) the investment banks, which package the loans into securities with different levels of risk, and sell the securities to investors.

This brings us to the tale of the two Bear Stearns hedge funds, which were investors in the high risk, high yield, sub-prime mortgage backed securities market. In the 6/20 front page story referred to above that discussed the two Bear Stearns' hedge funds facing a shutdown because of investments gone bad in the sub-prime mortgage market, the article states "the Bear Stearns hedge funds' problems are emblematic of the widening fallout from the nation's housing downturn….During the housing boom in the first half of the decade, lenders issued record volumes of mortgages, often on very generous terms, then packaged those mortgages and sold them off to investors, reducing their exposure to any loans that went bad….Now the housing market slump is causing a spike in mortgage delinquencies and defaults, which hurts the value of those bonds….Another sensitive issue: markets for exotic investments like derivatives linked to sub-prime mortgages have exploded in size…but it is often hard to attach an accurate value to those assets…," particularly when many investors want to sell at the same time. "Unlike stocks and treasury bonds, whose prices are continually quoted and easily obtained, many of these derivative instruments trade infrequently and don't have clear market prices." A further problem arises with the use of borrowed money to support the investments: "A high level of leverage, or use of borrowed money, magnifies returns for the fund if everything works as planned, but if the security drops in value, that same leverage can amplify losses." The Bear Stearns funds owned mortgage backed bonds, corporate bonds, and/or other leveraged loans, all under the general heading of CDOs (collateralized debt obligations).

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Another WSJ article (6/23-24, B1) describes CDOs as "financial vehicles that bundle different kinds of debt, ranging from corporate bonds to securities underpinned by mortgages to debt backed by money owed on credit cards, and cut that debt into slices, which are then sold to investors in the form of bonds. While the slices contain the same debt, they differ in terms of which pay the most interest and which are least at risk of losing money. Slices that pay lesser amounts of interest are the last to get wiped out by losses if there are defaults in the debt pooled in the CDO."

A NY Times signed opinion article (7/1, first page of Sunday Financial section), titled "Risk Aversion Therapy on Wall St.", provides a summary of some of these recent events. First, Blackstone's shares fell below their offering price. Second, "in the corporate bond market, investor risk aversion was evident when at least eight companies decided to postpone or pull their planned sales of securities." Third, "risk aversion is also showing up in the derivatives market, where the issuance of CDOs is slowing. Fourth, "the mortgage market continues to reel." The writer, Gretchen Morgenstern, states that "the mortgage market's woes were the first to tip the balance, but corporate bonds, stocks and private equity will also feel the effects of a pullback in risk taking (this is her opinion; at PPA, we do not make these kinds of predictive statements that use the word "will"). She continues: "There is, as always, a historic parallel…the late 1980s and another easy money era when a real estate bubble and takeover mania were fueled by the issuance of risky securities, in that case junk bonds….Today we have sub-prime mortgages being financed by hedge funds, pension funds, insurance companies and other institutional investors. But these same investors have also been lax in their lending to corporations issuing debt, often at the behest of private equity managers who hope to take those companies private."

Park Piedmont's view of all this: First, we would summarize the basic components of the problem as follows:

1) Difficult-to-value investments that are also
2) Highly leveraged, and
3) Loaded with fees from various intermediaries who participate in creating the investments, which are then
4) Purchased by various investors trying to achieve above-average market returns, and willing to take the risks associated with the attempt to earn those returns.

Second, since Park Piedmont's investment approach is to create an asset allocation appropriate for each client's specific goals, and then to implement that allocation with a broadly diversified mix of investments aimed at achieving those goals with the lowest feasible price volatility, we seek to avoid the specific investments that are currently creating problems in the financial markets. Excessive risk taking in an effort to achieve above-market investment returns is not what we do. Nonetheless, problems in the kinds of investments discussed above have the potential of adversely affecting other investments, and therefore we think it important for our clients to have an understanding of the relevant issues.

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