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Stocks provided a generous boost to portfolios during the second quarter, motivated primarily by favorable corporate earnings reports and economic conditions that were neither too hot nor too cold. The rally was welcome news coming on the heels of the rough patch we experienced in February, and it is a good example of why we believe a consistent investment strategy will generate better results for investors than efforts to “time” the ups and downs of the capital markets.

The topics we highlighted earlier in the year are generally playing out as expected. Reports continue to show some inflationary risks in an otherwise moderate growth scenario. Consumer spending has held up rather well, in spite of the softness in housing and tightening credit conditions. Surging tax receipts have motivated high levels of spending by federal, state and local government agencies. Businesses are flush with cash, and merger activity is running at an all-time high. In the first half of the year, an astounding \$2.8 trillion of deals were announced around the globe, with activity in Europe outpacing the U.S. volume for the first time in four years. Hedge funds and private equity firms are armed with a huge war chest of money, and relatively low borrowing costs provide ample leverage to do bigger and bigger deals.

While overall spending and merger activity have been supportive of stock prices, there continue to be areas for concern. Supply worries pushed oil prices back over the \$70 per barrel level, serving as a reminder that much of the world’s petroleum reserves are located in countries that are hostile to the interests of western economies. High energy costs are just one way international politics can affect consumers’ pocketbooks. Headline news stories seem to highlight a growing list of countries that pose an economic or national security risk with the potential to disrupt capital market conditions. Commerce is increasingly a global proposition, which means people around the world need each other even though they struggle to get along with one another.

Residential real estate is still on vacation. The inventory of unsold homes is at a multi-year high, which means subprime borrowers are not able to rely on rising home prices to bail them out. That is causing a surge in delinquencies and troubles for hedge funds that speculate in the mortgage area. The old adage says “when the tide goes out, you see the rocks.” Already, two hedge funds at Bear Stearns are in serious trouble due to failing bets on the subprime mortgage market, and it will not be surprising to find out that additional players are in a similar pickle.

At their June 28 meeting, the Federal Reserve once again decided to take no action with short term interest rates, citing slowing activity but with inflationary risks percolating in

the economy. While the Federal Reserve stands pat on their guidance, the bond market has taken its own action with respect to interest rates. Yields for intermediate and longer maturity bonds moved up by about a half percent during the second quarter. The move was enough to return the yield curve to a normal, upwardly sloping shape, with yields on longer maturity bonds now slightly higher than the yields for shorter maturities. We welcome this shift, and would like to see the slope gradually increase during the second half of the year.

It was a productive first half of the year. Stocks turned in a solid performance, and the bond market righted the yield curve even without any nudge from the Federal Reserve. Weakness in the housing sector, and the related subprime mortgage mess, has not created too much drag on the economy. The worrisome geopolitical headlines in the news have, for the most part, dealt with risks that appear to be already priced into the capital markets. We are maintaining our defensive posture with the bond portion of client accounts, sticking with high credit quality issues of relatively short maturities, and we continue to focus on corporate profit growth to keep the stock holdings on a positive course.

If you have any questions or thoughts you would like to discuss, we welcome your call.