



Regatta Research & Money Management, L.L.C.

In-House Market Strategy Update

September 1st, 2007

Breaking News

The Battle Wages On

The battle between the bulls and the bears on Wall Street continues to rage. The bears would have you believe the world economy is headed for a major fall as liquidity problems, the ability for assets to be converted into cash, arise around the globe. They believe the S&P 500, a market benchmark that tracks the performance of 500 of the largest US companies, topped out in early July and that the credit-market crisis will suffocate business activity slowing American consumer spending. The bears see the US economy in the midst of an intensifying thunderstorm where the dark clouds aren't passing, but are accumulating.

The bulls believe these summer storms are intense, but are just that, summer storms. They come out of nowhere and are sometimes stronger than you expect, but pass quickly and give way to blue skies. The bulls believe that the world economy is not falling apart, that corporate profits have been higher than expected in most countries and that stocks are still inexpensive.

Where does Regatta stand?

Regatta sides more with the bulls. From a macro-economic standpoint, we see the world economy as a whole doing quite well. At present we are in the midst of a perfect financial storm. Ongoing hedge fund problems; sub-prime issues; news of weak retail sales; fears of recession; and uncertainty over the skill of the new Fed Chairman, Ben Bernanke, have all led to uncertainty which is impacting the markets.

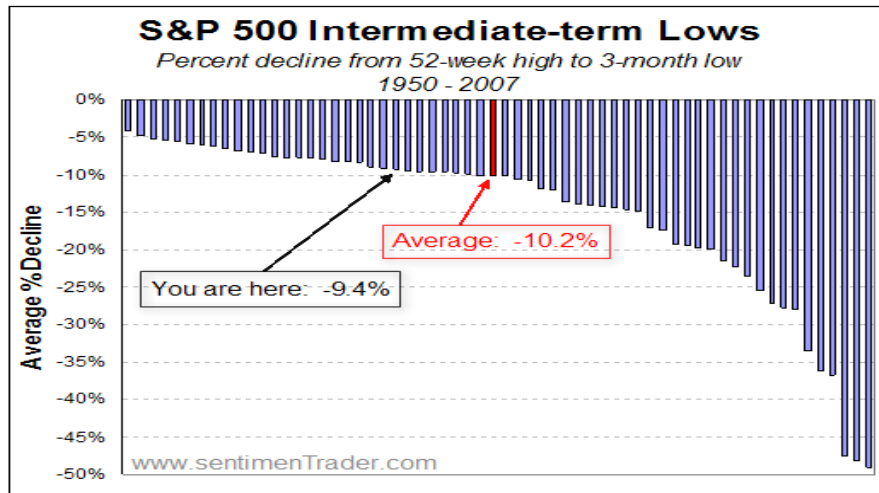
Our view is that most of these issues are highly overblown by various media outlets. The large drop in many stocks and bonds has less to do with inherent values than with overly fearful investors. Many large hedge funds, institutions, and financiers are being forced to sell securities they bought with borrowed money. Lenders are now requiring more collateral, causing forced selling of these assets, which drives down the market price.

However, these pullbacks can present opportunities. US stocks are as close to being as cheap as they have been than at any time since 1995, as measured by corporate earnings. Two weeks ago, shares of companies in the S&P 500 were down about 10% from their highs. Generally, the growth prospects of these companies haven't changed. US corporate profits are increasingly dependent on overseas sales and, although the American economy does face some troubles, the world economy is enjoying one of the biggest booms history. China has reported record industrial production. European growth is still expanding at a healthy pace and even Japan remains a 2% grower, despite all the market turmoil. All in all, the world economy is still doing great. We see this as a good buying opportunity once the dust settles.

Was this a typical bull market correction or something more serious?

Less than a month ago the S&P 500 was just about at new yearly highs, but since then it has suffered quite a bit. Looking back at intermediate declines in the history of the S&P 500, we find about 62 intermediate-term lows (meaning prices didn't violate the low for three months before and after that date) since 1950. The drops ranged from just under -5% to more than -50%, with the median of -10.2%. The current correction is pretty close to the average at -9.4%, so it seems to be right in line with prior lows. (see chart on top of next page)

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The chart below shows the S&P 500 over the past 10 years. As you can tell we have been in a bull market since 2003, and it has been common to have corrections throughout the bull market run. Usually the market stabilizes, then continues the trend upward.



How bad are all the subprime issues?

The subprime fallout and estimated financial costs from the mortgage crisis are an unknown in the market place. The Fed estimates it to be about \$65 billion, while some of our research estimates the number closer to \$165 billion. The key point is that even using the more aggressive estimate, this is much smaller than the Savings and Loan crisis of the late 80's to early 90's. The S&L losses amounted to about 3% of GDP, while the subprime fallout could be close to 1% of GDP. While we are not trying to understate the subprime shock, investors should put it in perspective.

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It is also worth recalling that the Savings and Loan crisis of the 1980's prompted the Resolution Trust Corporation to step up and bail out the lending institutions. The bad debt essentially became part of the Federal government's budgetary deficit. It may be necessary for Fannie Mae and Freddie Mac to step in and provide support to failing institutions that have a large exposure to subprime mortgage loans. This could help stabilize the asset base for the financial system, eliminate doubt, and help restore confidence.

Why was there a selloff in emerging markets?

Regatta believes the recent decline in emerging markets was primarily triggered by blind and indiscriminate selling among panicked investors. Selling was based on the concern that the credit and mortgage crisis could possibly spread, not on any significant fundamental change. With central banks around the world adding liquidity to the financial system, markets should become more efficient in discriminating between markets with good and bad fundamentals. We believe the bull market in emerging markets is still intact. Equities unrelated to the US credit market problems should benefit the most from the recent weakness, because their downdraft can largely be explained as pure collateral damage.

A bull market is characterized by a pattern of ascending bottoms, meaning the bottoms should be no lower than the peak preceding the previous selloff. Looking at the chart below, we see this is currently the case in emerging markets. Stock prices are rebounding from levels close to the peak prior to the February and March correction. If indeed we are in a bull market, we believe this level should hold and we continue to look for entry points back into emerging market stocks.



What is Regatta's view on the Fed's move to lower the discount rate?

The Fed's 50 bp cut in the discount rate signals that it is ready to act forcefully to stabilize markets and help restore investor confidence. While this is more limited and directed than a cut in the Fed funds rate, this move shows that the Fed intends to head off the risks of an all out credit crunch by interest rate relief and pumping liquidity into the markets. While we still believe that a cautious approach is in order for the short-term, the concerted policy response should put a bottom under risky assets and pave the way for a rebound.

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So where do we go from here?

While we do not hold a crystal ball, we believe that the lows on August 15 will hold and that a rehabilitation phase has begun. US economic growth could be below trend for the near future, but an outright recession is unlikely. We believe the latest correction has more to do with irrational actions, rather than fundamental changes. Ultimately it is economic growth and profits that dictate equity market trends. With this being said, the world economy is still very strong. This has explained the continued strength in industrial commodities along with the quick recovery of many emerging stock markets. We see little tangible evidence of the subprime impact on the rest of the world economy; it should continue to grow at a robust pace. This implies overall global growth could still be around 2-3%, a level we believe is too strong for a bear market in stocks to take hold.

In summary, while we continue to have a positive view on the market going forward, our primary objective is to protect your nest egg. During these times of volatility we are watching our stops closely, raising cash, hedging and moving more toward defensive stocks. Our flexibility and ability to adapt your portfolios on an ongoing basis is one of the reasons behind our success.

We thank you for your continued patronage and support!

Sincerely,

The Regatta Research Team

P.S.: If there is someone you know who would like to receive this market outlook, please contact us at 504-831-4636 or e-mail us at info@regattaresearch.com, and we'll be glad to send them a copy.

Disclosure

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