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To Our Clients:

For nearly the last decade, we have written a quarterly newsletter with commentary on the economy and market. That format has served well to communicate our viewpoints. The situation is different now. We are going through an historic period of financial change and turmoil. The regular newsletter format seems somehow not appropriate. Instead, we will try to provide our perspective in the form of an old-fashioned letter.

The Macro Picture: Sentiment rules the day

One of the big wealth management firms recently headlined its market outlook with the famous Franklin Roosevelt quote: "The only thing we have to fear is fear itself…"
Their use of this quote then provided the context to make some firm points. The events of recent months have been driven heavily by psychology rather than realities. We are not facing another Great Depression. Despite its stresses, the financial system is not going to collapse. To fall into a state of panic only serves to fuel the turmoil.

At Hudson Advisors, we like to act as calm, rational people. But we understand why emotion and sentiment are so powerful right now. To be rational requires having some confident grasp of the facts. Instead, we have extreme confusion and dramatic change in the established rules of the market system. The financial icon, Alan Greenspan, has confessed to being in "a state of shocked disbelief." So, okay, that makes it a little easier for the rest of us to admit that we do not fully understand what is occurring. We are not panicked – but we do find it hard to speak with any sense of certainty.

With that caveat, let us provide our best possible interpretation of the "big picture" and our own strategy to manage client portfolios in the period ahead.

The Financial System: Weakened, but able to function

Once the sense of crisis abates, we will face extensive post-mortem analysis. Should Wall Street have been trusted to manage its own risk – or should Government regulation have been more aggressive? Once financial panic

surfaced, did the Government respond too slowly? Should Lehman Brothers have been saved? Was Henry Paulsen more reactive than proactive? Time will provide perspective to answer these key questions.

At this moment, however, we believe the financial system is gradually stabilizing. Pragmatism has prevailed over ideology. Central governments in the United States and other countries have acted to preserve the banking system. Even should losses related to housing debt worsen, we believe the central governments will keep the banks solvent through a combination of capitalization, asset purchases, borrowing guarantees, and commercial paper purchase. Signs of this confidence are now evident. Credit will be available to meet the basic needs of businesses, state and local governments, and households. The financial system has been altered permanently – but it will function to preserve the flow of economic activity.

The Economy: Rough times ahead, but for how long?

The U.S. economy appears to be plunging into what will be the worst recession since 1982. While the banking system has been saved, the collateral damage to the economy is extensive. The economic news is mostly bleak. Retail sales are slumping. Industrial production is falling. Housing prices are still declining. Unemployment is above 6% and some experts say it could reach 8%.

The heart of the problem lies with the U.S. consumer, whose activity accounts for over 70% of the domestic economy, and whose appetites have fueled growth here and in the emerging market economies. Although available, credit conditions are tightening on everything from car loans to credit cards to home equity. The era in which easy credit pumped up the economy, here and abroad, is seriously curtailed.

How long will the recession last? At Hudson Advisors, we expect the third and fourth quarters of 2008 to show negative growth – with cumulative decline of about 5%. The first two quarters of 2009 will also certainly be negative – perhaps in the 2% range. Beyond that time frame, our crystal ball is cloudy. Some positive forces are at work. The decline in oil prices helps. Some further rate cuts by the Federal Reserve can assist marginally. A second major economic stimulus package, already underway in Congress, should boost consumer confidence. We think it possible – albeit not guaranteed – to see gradual recovery by the second half of next year.

The Stock Market: Where is the bottom?

We do not need to recap what has occurred in the stock market in recent months. Regular conversation with our clients tells us they are painfully aware that equity values are down about a third for the year. The market has reacted badly – often

with emotion – to the onslaught of bad news, first about the financial system, and now about the economic outlook.

We expect the market to remain volatile and uncertain for at least the next several months. The unknown extent and depth of the recession creates tremendous anxiety. Feeding the gloom is weak corporate earnings – with profits in the S&P 500 companies having declined year-over-year in each of the past four quarters. As a result, the equity rout is widespread – with all 10 major industry groups in the S&P 500 showing price declines in 2008. To compound the problem, we suspect the market decline is exacerbated by hedge funds facing margin calls, or demands to repay borrowed money used to buy shares whose value has dropped.

Despite these comments above, we believe the market is still governed by some fundamental behaviors. One of those behaviors is the idea of "capitulation" – when the market reaches its bottom – and long-term investors are then enticed to start buying again. We are not certain when this point of capitulation will be reached. However, our experience tells us that markets historically rally 6 to 12 months ahead of the economic fundamentals. Thus, daring to be cautiously optimistic, we think it possible that the market will reach its bottom sometime in 2008 and begin a gradual recovery as we head into 2009.

Our Investment Strategies

Given the sense of panic and uncertainty, many investors have gone to the perceived safety of insured bank deposits, cash equivalents, or short-term Treasury instruments . In a recent article, Warren Buffett explained the poor wisdom of that choice for investors with any kind of long-term horizon. Those assets are paying practically nothing and inflation will actually give them a real return that is negative. Mr. Buffet's advice was simple: Buy equities. Despite all the current problems, his argument was that most American companies will be making record earnings 5, 10, and 20 years from now. Equities remain the best long-term investment – a viewpoint we share at Hudson Advisors.

1. **Equity Preferences**: For our long-term investment clients, our industry preferences for equities remain similar to recent quarters:

- HEALTHCARE: We still like companies that serve the needs of an aging population, such as respite care facilities and makers of medical devices. We also think that biotechnology companies have strong long-term potential.

- CONSUMER STAPLES: Companies which meet basic household needs should sustain profit growth even if consumer spending declines for more discretionary items.

- INDUSTRIALS/TECHNOLOGY: We see value in technology and certain industrials – such as those that offer productivity and power management solutions,

- ENERGY: Despite the recent price declines, the long-term imbalance between supply and demand creates profit benefit in production and exploration companies. The traditional alternatives of coal and natural gas are also attractive.

2. **Covered Call Writing**: As explained previously, we actively engage in writing covered calls in portfolios. This strategy allows an investor to enhance return on a stock position in a flat to falling market. If you own a stock you can sell someone else the right to buy it at a higher price. If the stock is likely to stay below the agreed selling price, you keep the call premium paid to you without actually having to sell the stock. This collected premium acts like an extra dividend payment on the stock. This strategy can produce extra yield of 4- to-10%.

3. **Alternative Investments**: We have maintained a 5- to-10% allocation to structured notes and diversified hedge fund strategies. The attraction of these vehicles is that they offer what some analysts call a "turtle strategy" – which means they can do well regardless of what direction the market takes. They fit into a defensive posture appropriate for this environment.

4. **Municipal Bonds**: For clients wanting fixed income investments, tax-exempt municipal bonds are extremely attractive right now. Governments need to borrow despite cautious demand and, thus, yields relative to taxable bonds are at a record level. Investors in the highest tax brackets are receiving tax equivalent yields in the 8.5-9% range.

Conclusion

Recent months have been a humbling and anxious time for those of us in the investment profession – and for many of our clients. The prognosis for the economy and the market in the next year is extremely uncertain. Longer term, we retain our confidence in equities as the superior asset class – even though we are including defensive strategies in management of client portfolios.

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