



DEIGHAN

ASSOCIATES

INVESTMENT QUARTERLY

DEIGHAN ASSOCIATES, INC. • REGISTERED INVESTMENT ADVISOR TELEPHONE 207 990 1117 FACSIMILE 207 990 1551

Year End 2007

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Some might argue that the weather is not unlike the financial markets.

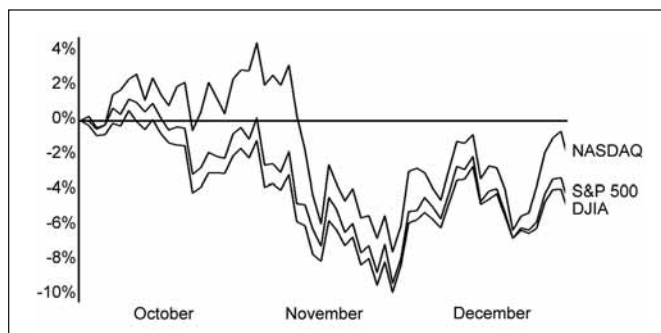
MARKET COMMENTARY

Greetings from Winter Wonderland! What a snowy start to the season! Despite around-the-clock efforts by road crews, we still can't see our neighbors for the snow banks. Everything has slowed down out of necessity, and we have been forced to adjust to our environment to avoid slips and falls. As we heft our shovels and dig into the white stuff, we find ourselves stunned by the reality that winter has merely just begun. Some might argue that the weather is not unlike the financial markets.

Both the S&P 500 (5.49%) and the Dow Jones Industrial Average (8.8%) finished 2007 in the black, but the year was a turbulent mix of sunshine and storm clouds. Over the

became more pronounced and loan defaults increased. Shortly after breaking the 14,000-point barrier in mid-July, the Dow lost nearly 1,200 points by mid-August. The first heads to roll were those of subprime lending companies. Then the misery spread to the sellers and owners of repackaged subprime mortgage debt. The broader mortgage-backed securities markets dried up, and banks were unable to issue commercial paper to finance legitimate operations. Some banks with large subprime exposure were forced to take hefty write-downs, and several hedge funds closed shop. We covered these developments in past quarterly mailings.

Bankers and regulators have since been



Period: September 30, 2007 - December 31, 2007

4Q07 Investment Results:

NASDAQ Composite

S & P 500

The Dow Jones Industrial Average

past few years, many asset classes have enjoyed record highs, making it a challenge for investors to find meaningful opportunities at attractive prices. In late February, a correction in emerging markets resonated with U.S. markets, causing both the S&P 500 and the Dow Jones to drop significantly. Though markets quickly recovered, the drop highlighted two issues. One, the five-year bull market was susceptible to losing momentum. And two, global equity markets and domestic markets were perhaps more closely tied than was thought.

For the next few months, market participants soaked up the sun, while the Dow Jones Industrial Average and the S&P 500 pushed into record territory. However, skies darkened by mid-summer, as the housing downturn

striving to plow through the debris that has clogged and stalled the streets of the credit system. If only it were as simple as plowing snow! Investors have exited financial stocks in droves, now that more and more companies have come forward about the extent of their subprime exposure. Unfortunately, the past six months have been a nasty storm, and the conditions are such that it's difficult to know just when we'll see clear skies ahead.

However, just as a Downeast blizzard brings out neighbor to help neighbor, the bankers and insurance companies are not going it alone. The Federal Reserve coordinated a series of worldwide efforts with other central banks to inject liquidity into global markets. A few foreign state-run funds have also provided cash to struggling firms in

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exchange for ownership positions. On December 11th, the Federal Reserve cut rates for the third time in 2007, which brought the federal funds rate to 4.25%, one full percentage point below where we started the year.

Many on Wall Street are still calling for further rate cuts, and if policy over the past few months has been any indication, they will probably get them. But this expectation to cut rates presents the Fed with a problem. A reduction in interest rates can amplify inflationary pressures, something the Fed has long been careful to control. Between June 30, 2004 and June 29, 2006, the Fed raised rates 17 times, from 1.00% to 5.25%, in an effort to dampen what looked like an overheating economy. Rates were not lowered until September 2007, after the effects of the mortgage meltdown had become pronounced. In the Fed's view, there had to be a strong case that economic growth was actually slowing before cuts could be made. In other words, the risk of the economy slowing or dipping into a recession had to outweigh the risks of inflation.

A big challenge in using monetary policy to combat economic ills is the time it takes for changes to filter through the broader economy. In the short-term, markets may herald action with a brief rally, but the true effects of monetary policy are not usually felt for months to come. Furthermore, rate

Lower returns cause lower demand for U.S. securities, and, in turn, for the dollar. Over the past several years, because of record U.S. debt levels, a poor balance of trade, and growing uncertainty over the economy, international investors have diversified away from the dollar into other currencies. Lower rates have exacerbated this trend. Meanwhile, the Canadian dollar has benefited from Canada's strong export and commodity-driven economy, especially in a time when demand for commodities has been high.

It's hard for any red-blooded American to continually hear about the dollar's decline against other currencies. But there are positives to be had with a weak dollar. For one, it makes American-made goods cheaper to foreign buyers, increasing demand for American exports. For another, it increases foreign direct investment in American businesses and infrastructure. While this is not always viewed as a positive thing, it can result in new jobs for Americans. And finally, for investors with international securities in their portfolios, international returns have been greatly enhanced by foreign currency appreciation relative to the dollar. In 2007, the MSCI EAFE Index returned 11.17% for U.S. investors, but only 3.54% for investors in the local currencies.

Looking toward what's in store for 2008, we expect a continuation of the volatility

*During unstable times, the importance of
a well-diversified portfolio cannot be overstated.*

changes can create abnormalities, such as inflated consumer debt and housing bubbles. These have both been side effects of the Fed's soft money policy, which lasted from 2001 to 2004. Ultimately, we will have to wait and see whether the Fed has made, and will continue to make, the proper monetary decisions.

Related in part to the Fed's actions has been the continued slide of the American dollar compared to other major world currencies. In mid-October, the dollar fell to a 33-year low against the Canadian dollar, and it has continued to break all-time lows against the Euro. Several issues factor into currency valuation, but lower interest rates tend to result in lower returns on U.S. denominated securities, such as Treasuries.

that has shaken markets in 2007. By most measures, the housing downswing still has some room to go, and economic indicators point to a slowing economy. Consumer spending, the backbone of the economy, is at risk for a few reasons. First, tightened lending standards are making it harder for consumers to get loans, and declining home prices are reducing home equity. Second, corporate earnings are expected to slow, resulting in a weaker labor market and decreased job/wage growth. Finally, with oil breaking through \$100 a barrel, many folks are doing all they can just to keep their homes heated.

During unstable times, the importance of a well-diversified portfolio cannot be overstated. We've witnessed a lot of herd behav-

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ior over the past six months, with undisciplined investors switching between “riskier” equities and “safer” bonds. Because it is so difficult to know just when markets will move, it’s best to be simultaneously invested in a variety of asset classes. This long-term strategy served our clients quite well throughout the turbulence of 2007, and we expect it will continue to do so going forward.

The adversity brought on by a heavy snow or bumpy markets can make us wary of what’s next. However, it’s important to

keep in mind that, like the weather, both the markets and the economy tend to work in cycles. The legendary investor Peter Lynch stated, “Tough markets are like winter. When faced with winter we don’t panic, we just throw on a coat with the knowledge that spring will come!” Even though it’s cloudy now and the short-term outlook is uncertain, the best thing to do is pick up the tools at our disposal, be they snow shovels or diversified portfolios, and work through to clearer skies ahead.

PORTFOLIO CHANGES

The following portfolio changes do not affect all client accounts. If you have questions, please call us at 800-990-1117.

Winslow Green Growth Fund (WGGFX) – Added – Many of our clients have inquired about environmentally friendly investing, and when a spot opened up in our small cap portfolio, we decided this fund would be a good fit. The fund’s two managers have over 43 years of combined green investing experience, and the fund itself offers exposure to a variety of areas, including non-polluters, renewable energy, resource efficiency, and so on. A risk with green funds is that returns can sometimes be sacrificed for the greater good. To date, however, Winslow Green Fund has consistently delivered strong returns against its small cap peers. Because of its relatively concentrated portfolio and mission, we have limited this fund’s role to that of a supporting player.

Artisan International Fund (ARTIX) – Added – Over the past few years, we have strategically increased our allocation to international equities. International stocks offer significant advantages in a growing global economy. To reflect this increase, we have added another fund to help mitigate manager-specific risk and further diversify our portfolios geographically. Mark Yockey, manager of Artisan International Fund, is an industry veteran who has maintained his growth discipline for years. He is also a patient investor with an eye for valuation. This fund compliments our other core international holdings.

Whole Foods Market (WFMI) – Added – Whole Foods has carved a niche among customers who desire a high quality shopping experience combined with a commitment to wellness and the environment. Earnings have been depressed recently due to the costliness of expansion initiatives within the firm. We view these initiatives as laying the groundwork for growth in shareholder value over the long term. The company is far from saturating its existing and potential markets, and its premium branding allows it to command sales per square foot that are roughly twice those of conventional grocers. Recent market turbulence has made this stock an attractive buy, and we have added shares to equity portfolios.

Citigroup (C) – Removed – Citigroup performed well for us over a number years. However, the company has been hit hard by the subprime mortgage crisis. Nearing the end of 2007, Citigroup estimated that its mark-to-market losses on illiquid securities could be as high as \$17 billion due to subprime securities exposure in its portfolio. The health of the company’s capital ratios has also come into question. Given the volatility and uncertainty surrounding the financial sector, we have decided to exit our position in Citigroup.

Disclaimer:

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Soundbytes

Jean Deighan attended IMPACT 2007 in Las Vegas, a three-day conference celebrating the 25th anniversary of Schwab Institutional. Featured were a number of educational sessions covering such topics as globalism, portfolio management, diversification, retirement planning, and compliance. Speakers included Bono and the international editor for Newsweek, Fareed Zakaria.

Dawn Hanson and Jenifer Wilson attended the Baron Funds Conference in New York City. Featured speakers included CEOs from WebMD, J Crew, Edwards Life Sciences, Morningstar, Inc., and Penske Automotive. Presentations were also made by Baron’s fund managers.

Dawn Hanson attended, “Preventing Critical Financial Mistakes During Divorce.” The seminar addressed the handling of personal affairs after divorce, valuation of assets, important issues relating to Qualified Domestic Relations Orders, and information on the income tax consequences of asset division.

HAVE A PLAN AND START EARLY

Everyone likes the idea of saving money come tax time. Newsstands are replete with magazines and journals full of tax tips. If we were to limit ourselves to just one tip, it would be this: Have a plan and start early!

Step one – Have a plan. Your plan will vary depending on your specific situation, but most plans focus on two aspects of your finances: your day-to-day budgeting needs, and your overall net worth.

Day-to-day budgeting becomes important when trying to figure out how much money to sock away into retirement accounts, such as IRA's and 401(k)'s. Contributing to these accounts allows you to defer paying the tax-man now, and it lets your investments grow tax-deferred until retirement. For example, the contribution limit for IRA accounts in 2007 is \$4,000 (an additional \$1,000 catch-up is available to individuals over age 50). If you were to contribute to an IRA up to the limit, then your taxable income for 2007 would be reduced by \$4,000. Employer provided retirement plans, such as 401(k)'s and 403(b)'s, offer the same bene-

around tax season, and it will force you to better organize your finances throughout the year. By the same token, automatic payroll deductions for employer sponsored 401(k)'s and 403(b)'s give you the discipline to save, and many employers match your contributions dollar for dollar up to a certain limit.

Estate and gift taxes can be a little more abstract. That's why it's also important to map out your overall net worth as part of your tax plan. A good way to go about doing this is to create and maintain a Net Worth Statement (NWS). Let us know if you would like us to provide you with an NWS form that walks you through the process. Tax law is set to undergo several changes over the next few years, but with an NWS in place, your estate attorney will have the information s/he needs to create a sensible plan for you, both now and when laws change. The chart below illustrates how estate and gift taxes are set to change over the next four years.

Now that you have your plan, let's look at that second step of our tax tip – Start early. When it comes to retirement accounts, it's

YEAR OF GIFT/DEATH	\$ ESTATE TAX EXEMPTION EQUIVALENT	\$ GIFT TAX EXEMPTION EQUIVALENT	MAXIMUM TAX RATE FOR TAXABLE \$ AMOUNTS EXCEEDING	
2008	2,000,000	1,000,000	45%	1,500,000
2009	3,500,000	1,000,000	45%	1,500,000
2010	Repealed*	1,000,000	35%	500,000
2011	1,000,000**	1,000,000		

* The repeal of the federal estate tax is accompanied by a repeal of stepped-up income tax basis as we know it now, to be replaced by a new hybrid system.

**Unless Congress acts, in 2011, the estate and gift tax rules will "sunset" and revert to pre-2001 Act law.

fit. The money you contribute to your retirement plan comes as a pre-tax deduction from your paycheck, lowering your taxable income for the year. In 2007, the maximum elective deferral for 401(k) and 403(b) plans is \$15,500 with an additional \$5,000 for individuals over age 50. Keep in mind that Roth IRA contributions are not tax deductible, though distributions are tax-free at retirement.

So, how much money can you afford to contribute each period? That's where a budget comes in handy. If you systematically contribute to an IRA over the course of the year, then you won't need to come up with \$4,000 on the spot in April. This will minimize the risk of running into cash flow problems

never too soon to start saving. The power of compounding is an incredible thing, and it's even sweeter when your investments grow tax-deferred. It's also never too early to start analyzing the estate you will one day leave behind to your loved ones and/or your favorite charity. None of us knows just when our time will come, but a well-thought-out estate plan can make life a lot easier for those we leave behind.

Taxes can be both confusing and expensive. But with some planning and initiative, allowances are in place to help you save money. Should you have any questions, never hesitate to ask us.

DEIGHAN ASSOCIATES

REGISTERED INVESTMENT ADVISOR

TELEPHONE 207 990 1117

FACSIMILE 207 990 1551

www.deighan.com

DEIGHAN ASSOCIATES, INC.

REGISTERED INVESTMENT ADVISOR

455 HARLOW STREET

BANGOR, ME 04401

JEAN M. DEIGHAN
PRESIDENT

jeandeighan@deighan.com

JENIFER L. WILSON, CFA
VICE PRESIDENT

jeniferwilson@deighan.com

DAWN M. HANSON, CFP®, CDFIA™
PORTFOLIO MANAGER
dawnhanson@deighan.com

MATTHEW T. SKAVES
PORTFOLIO MANAGER
matthewskaves@deighan.com

KAREN S. MITCHELL
ADMINISTRATIVE ASSISTANT
karenmitchell@deighan.com

HEIDI FARREN
OPERATIONS
heidifarren@deighan.com