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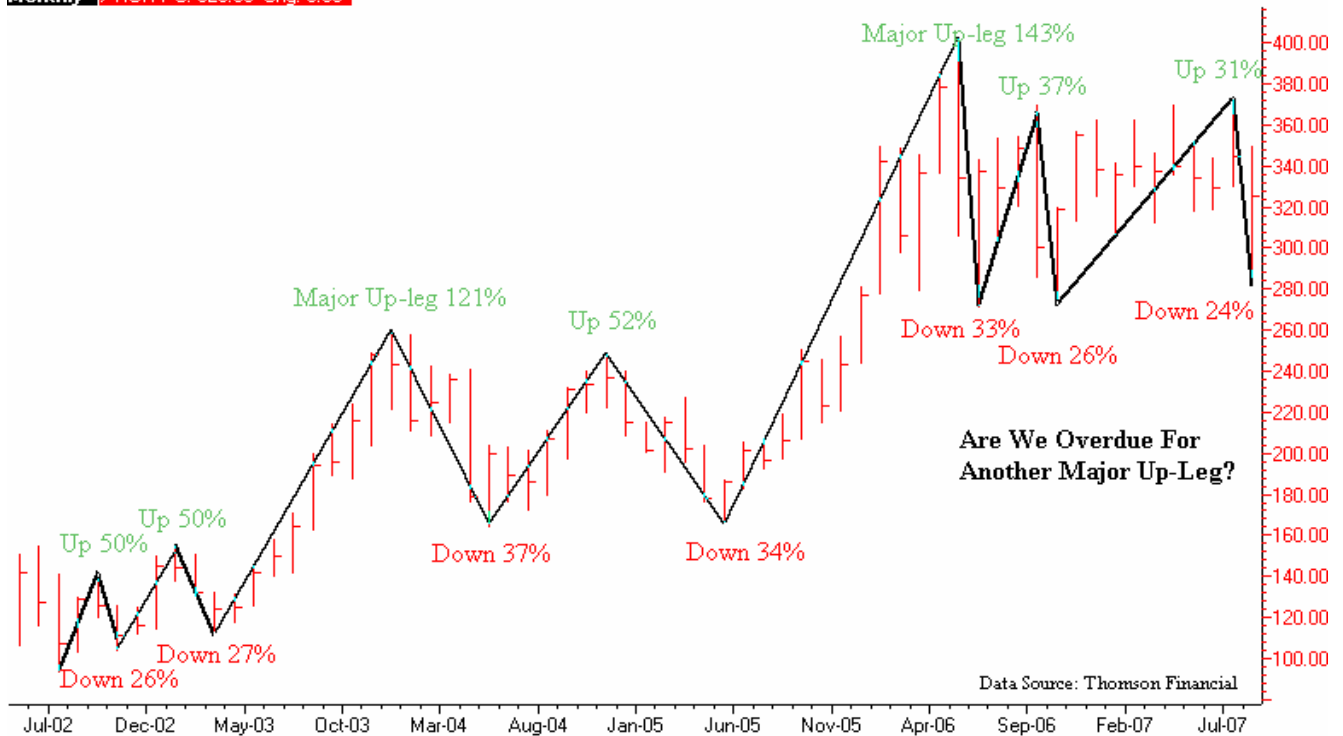
August 24, 2007 Commentary
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S&P 500: 1479
NASDAQ: 2577
Gold: 668

“No generation can contract debts greater than may be paid during the course of its own existence.” –*Thomas Jefferson, in a letter to James Madison in 1789*

Our portfolio consists of many companies from different industries but our concentration for the past few years has been in the resource sector. This sector, along with the broad markets, experienced a high level of selling during the past few weeks so I am focusing this *Commentary* on it.

Below is a five year chart of the HUI which is the Amex Gold BUGS Stock Index-an index of precious metals mining companies. Please take a look at how we've used this sector to underweight you in stocks and yet stay very close to or beat the performance of the S&P 500. More importantly, look at the pattern since the beginning of the bull in 2002: Every third, or so, up-leg has been a major up-leg. Notice how with even the violent correction we had over the past month the Index held support at the previous bottom around 270 to 280. The next major breakout would occur at 370. If that happens we will probably put all un-invested cash to work, if not sooner.



As the chart indicates, while we have recently and very rapidly experienced a lot of short-term pain we are still invested in one of the best equity markets out there: Resources and resource stocks, including Gold, Silver, Oil, Gas, Coal, and Uranium. The reasons to invest in companies that pull these items out of the ground remain valid, are indeed compelling, and have not changed at all despite recent volatility in all markets. The recent panic-driven activity was caused more by pooled groups of money seeing margin calls in unrelated and failing business. When you have a failing investment on margin and you receive a margin call, you often must sell more than what you owe in order to come back in compliance with margin regulations. Since these failing (mostly mortgage related) investments had few buyers, other healthy companies like ours had to be sold. As to the merits of what we own relative to the market, gold is still cheap as it still can be bought for less than the peak of the previous gold bull market in 1981 while most everything else is more expensive. And through the gold bull, gold and gold stocks have changed leadership several times with gold having the upper hand over gold stocks most recently. I think the end of gold stock under-performance is near just as I believe gold will continue to outperform the S&P 500 as it has since March of 2000.

The bullish case for real assets, that is, resources:

1. Demand continues to outstrip supply and will probably continue to despite a slowing U.S. economy due to the insatiable appetite and excessive U.S. dollar reserve balances of growing economies like China and India with growing middle classes. Through both cultural and financial experience, these two populations have a natural affinity for the accumulation of gold as real money. The appetite for oil, gas, coal, and uranium as a substitute, goes without saying.

2. U.S. Trade and Current Account deficits force increased borrowings of the U.S. Government which means more IOU's in U.S. Dollars that other countries will increasingly eschew for more reliable assets. The resulting value of the U.S. dollar against other currencies, including gold, will have quite a headwind with which to contend.
3. The U.S.'s long term debt and future obligations of some \$42 Trillion will only be satisfied by creating yet more U.S. dollars to pay it off which means higher prices for real assets.

We are taking 20-35% of your money and investing in these companies which I believe will produce better returns than what you might earn by investing a similar percentage of your holdings in broad U.S. stock markets. Unfortunately, this is a zero-sum game and I cannot emphasize enough that our strategy is meant simply to maintain your net worth after the inflation which means while you will hopefully earn more versus a similar weighting in broad U.S. stock markets, the earnings you gain will buy less than it used to due to the devaluation of our money through excessive government money creation. **By the way, every time you hear on the news about a central bank somewhere in the world staging a “liquidity injection”, that’s creating more money out of nothing. How long would you accept something growing in supply this quickly in return for your hard asset that is cannot be created out of nothing but a computer entry?**

To be sure, it will be a volatile ride but I am confident we are on the right track for the next 1-10 years. You will see a lot of activity as we take advantage of tax losses, change into new names and re-deploy cash into what appears to be a great buying opportunity. (If we have a loss, by selling the loss and buying another like-company, we can maintain exposure to the sector and use the loss carry-forward to offset realized gains in other stocks)

In the opening paragraphs I described “panic-selling” which took everything down. Could this happen again? It could, but panic selling happens when a lot of bad news is disseminated in a short period of time. I think everyone now knows that there will be millions of foreclosures in the next few years, that these Collateralized Debt Obligations are something to look at more closely before investing and most importantly, that the FED will come to the rescue if it gets worse. Thus, with the ‘dramatic unveiling’ behind us the only options for the broader markets are to resume climbing or, if the news just stays mediocre or bad, to grind sideways or lower...gradually. A similar trap was set after the September 11th attacks when the FED came to the rescue and all was thought to be okay. Then things just got gradually worse and most people kept thinking the markets would get better “after this one last bad month” until one month turned into another and another and you know how it played out. If the economy slows now this will happen again. If history is any guide, the resulting decline in interest rates which cause further dollar erosion can only lead to higher gold and gold stock prices. Gold went up as that bear market ensued and then, against all odds, has continued to rise even as the FED

brought rates back up. This tells me that, while it was a stealth gold market that the public has barely noticed, it is meaningful as a guide to the future.

The Indicators

“When Fear is at its height, Buy; When Greed is at its height, Sell” -my father, J.M. Gore Friedrichs. With these indicators, we try to assess the current levels of “greed” and “fear”. At times, we have contradictory readings and we simply balance them out to assess the current market environment. The best actionable points are when most or all of the indicators are in line.

Let’s look at the indicators explained below:

Contrarian

<u>Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current</u>	<u>Indication</u>
NYSE Bullish Percent	>70%	<30%	39.22*	Mildly Bullish
AAII Sentiment				
Bull/Bear ratio	>2.5	<1	.95	Bullish
NYSE+NASD				
Margin debit balances	>160B	<100B	\$408B-All-time High!!	VERY Bearish**
Savings Rates	<5%	>12%	.6%	Bearish
Mutual Fund Cash	<7%	>12%	4.5%	Bearish

*Declining from a peak of >86%

<u>Valuation Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Last here</u>	<u>Indication</u>
Price/Earnings Ratio	>20	<10	17.76	Bearish
Dividend Yield	<3.5%	>6%	1.76%	Bearish

<u>Monetary Indicator</u>	<u>Bullish</u>	<u>Bearish</u>	<u>Current</u>	<u>Indication</u>
Yield Curve Spread	>3.5%	<0	1.20	Bearish

* The last comment I sent out before this recent decline talked about how this indicator had finally reversed from above 70% where it was overbought. Now it has gone all the way back down to below 30% and reversed up which is an alert to watch for bullish behavior.

** With Margin Balances so high we are still vulnerable to declines that accelerate as for reasons discussed above.

Why These Indicators?

NYSE Bullish Percent: This great indicator I get from Dorsey Wright and Associates www.DorseyWright.com headquartered here in Richmond. This indicator tracks the percentage of stocks on the New York Stock Exchange currently on buy signals. Generally, the higher the number, the more buying has been done prior to the point of measurement. This could be an indication that less and less buying power remains out there, so at readings above 70%, we become cautious as the inevitable cycle of cash flowing in and out of the markets progresses. At levels below 30%, we become aware that a very good buying opportunity may lie ahead as most investors have probably already sold and are holding cash to fuel the next run.

AII Sentiment Bull/Bear Ratio: A weekly poll is conducted by the American Association of Individual Investors - what we call the individual public investors. This is a reliable indicator of the sentiment of individuals who are considered more emotional and less sophisticated than the “big money” investors. Since generally we don’t trust the emotions of the individual, this secondary indicator tells us when caution is warranted with high Bull/Bear ratio readings. Likewise, low readings can portend buying opportunities as markets tend to rally once the last little guy has bailed.

NYSE + NASD Margin Debit Balances: This is a monthly posting at the National Association of Securities Dealers’ (NASD’s) website telling us how much is currently being borrowed to own stocks. These are investors who actually borrow money to buy stocks and high readings generally indicate a frothy environment. The reason this is of particular value is that once the market turns, margin calls cause these borrowers to dump stock more rapidly in order to repay loans; thus, the risk in the market grows at something more like an exponential rate as these debit balances grow. Low debit balances indicate that these risk-averse investors have finally caved and now are flush with cash and fresh borrowing power, and thus, buying power.

Savings Rate: This is the national savings rate and is gleaned from the U.S. Personal Income and Spending monthly report. My view is that the lower the savings rate the less disposable income with which the emotional public can use to add to stocks. A higher rate, to me, indicates more reserves on tap to fuel a strong bull market. From a contrarian standpoint, this indicator also tells me how optimistic John and Jane Q. Public are about the future. Low savings rates indicate high levels of optimism and probably a correspondingly high level of risk tolerance. This can foster an inclination among investors to count on and indeed borrow against “future dollars”, which tells me to be careful.

Mutual Fund Cash: This is the level of cash held in mutual funds. Generally, less than 8% is bearish and greater than 10% is bullish. I go a little further and like to reduce my risk by waiting for buying opportunities closer to 12% cash and for selling opportunities at less than 7% cash. This works the same way as the savings rate except that this cash is professionally managed money ready to be put to work. Generally, the more cash available, the better.

Price to Earnings Ratio (P/E): The historical average is around 15. We also call this fair value. There are many justifications in certain periods of time to accommodate higher levels, but the key I focus on is the historical tendency over decades of market action for this ratio to gravitate toward its mean of 15. Specifically, greater than 20 represents extreme overvaluation (proceed with caution) and less than 10 represents extreme undervaluation (back up the truck because the next 15 years should be good!). I use the P/E of the S&P 500, which represents 500 companies across the economy. P/E's are available on The Dow and NASDAQ as well. Bear markets usually bottom with P/E's around 8.

Dividend Yield: Again, using the S&P 500, this represents the amount of real money being distributed to shareholders as a percentage of their investment (the stock price). The historical average is around 4-5%. The higher the market goes, assuming a fixed dividend stream, the lower the yield. The lower the market goes, the higher the yield. Bear markets usually bottom with yields around 8%.

Yield Curve Spread:

This indicator tells us the difference, or "spread" between yields (compensation for risk) being paid on short-term funds (three-month Treasury Bills) and long-term funds (30-year Treasury Bond). Normally, the curve is upward sloping; meaning investors are expecting more compensation for the risk of inflation arising over the long term. This implies an inherent confidence in pricing power, generally speaking, which bodes well for the economy and stocks. An inverted yield curve (spread<0) is a condition that exists when short-term yields are greater than long-term yields.

As you can see, the market is on tenuous grounds but barring any major panic-selling, our portfolio should fare very well. If you ever have any questions, please do not hesitate to contact me.

Successful Investing to All!

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