Tillar-Wenstrup
Advisors, LLC

NEWSLETTER

Second Quarter 2007

The Case for Quality…. Again

The stock market shrugged off rising interest rates, higher oil prices and further deterioration in the housing market to post solid returns across-the-board. The S&P 500 gained 6.3%. Strong sectors included energy (+14.3%), technology (+10.2%), and industrials (+9.2%), while the laggards included anything consumer related or interest rate sensitive, such as utilities (-1.1%), financials (+1.5%), consumer staples (+2.1%), and consumer discretionary (+3.4%).

The first two months of the quarter were very strong while rising interest rates and credit market worries were factors contributing to a drop of -1.8% for the S&P 500 in June. Consistent with our conservative discipline we outperformed nicely in June. Even more encouraging is our strong performance so far in the third quarter. Investors are starting to recognize the value in high-quality companies with a substantial stake in global businesses.

For the first time in a long time small stocks lagged large stocks in a strong market. We expect this outcome to be repeated due to big company's balance sheet conservatism, lower valuation, and greater exposure overseas. In fact, S&P 500 companies derive about 30 per cent of their sales overseas (compared with 15 per cent for smaller companies in the Russell 2000) and many of our holdings have significantly more business overseas than average.

While there are many risks for investors, conditions for high-quality (good balance sheet), globally-focused, attractively-valued companies continue to improve. The global M&A (mergers and acquisitions) market is very favorable for stock prices. The value of global M&A in the first six months of 2007 was an astonishing $2.7 trillion with American companies accounting for more than $1 trillion worth of deals.

This pace won't last forever and returns from current deals may disappoint investors, but the global M&A business will power ahead until either earnings start to falter or there is a serious financial market accident.

Until recently private equity firms (PE) have concentrated their acquisition efforts on small- and mid-capitalization stocks. However, valuations in this space are stretched and credit markets are becoming less accommodating in financing these deals. Many recent deals have seen PE firms go after larger capitalization companies (First Data, TXU, Alltel, BCE Inc. and Hilton Hotels, Chrysler, Clear Channel, Sallie Mae). Expect this trend for bigger deals to continue since PE has raised massive amounts of money that will need to be invested in the years ahead. According to Private Equity Intelligence, PE raised $240 billion in the first half of 2007 compared with less than $10 billion in all of 1991.

The outlook for earnings growth is another reason to favor global companies. Growth overseas is as strong as ever despite a slowdown in the U.S. According to Merrill Lynch, S&P 500 pretax profits derived from foreign operations surged 20% in the first quarter, while domestic profits slipped 0.4%. This condition is likely to persist since global firms are able to raise prices at a much faster pace than their domestic peers and should demonstrate more profit margin resiliency. The evidence suggests that foreign companies are depending less on the American consumer than in the past. However, the real test for all businesses will come if consumer spending starts to slow, since it accounts for 20% of the global economy.

Stock market volatility is on the upswing and we expect it to increase. However, conditions for permanent stock market losses are not in place yet. More importantly, we believe the long-term outlook for <u>our</u> stocks are excellent and they will solidly outpace our benchmark as the market rotates to favor high-quality, globally focused companies.

Thanks again for your business.

Jim Tillar, CFA and Steve Wenstrup
937-428-9700