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Memorandum

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TO: Clients and Friends
FROM: Glenn Kautt, President and Chief Investment Officer
SUBJECT: S&P Downgrade Memo
DATE: August 8, 2011

You may be aware the Standard & Poor's rating agency (S&P) announced Friday it was downgrading US sovereign credit rating from AAA to AA+. According to its own announcements and analysis presented over the weekend, the downgrade was due to both political and technical reasons.

Politics…but not "As Usual"

The political reasons were not an inherent dislike of Republican or Democratic politics. Rather, this unprecedented step came as a result of the lack of political *will,* that is, the ability of Congress and the Administration to come to agreement on how to manage the huge amount of debt this country faces. You may remember, S&P warned some months ago a failure by the federal government to realistically tackle the debt ceiling problem could lead to a credit downgrade. In a similar fashion, S&P already has announced a lack by the government to resolve both the short- and long-term debt issues in the coming months could lead to a further downgrade in both the short- and long-term credit ratings of US Sovereign debt. More on this later.

Naturally, the S&P action has triggered intense debate and concern. As one wag said "The guys who can't shoot straight were downgraded by the guys who can't count." All jokes aside, it doesn't take a PhD in economics to know taking in revenues of 40 cents while paying out $1.00 is not a sustainable or credible fiscal policy. The downgrade is precipitating a national debate which is moving into two more or less distinct policy camps. One is for a more socially progressive state as practiced by many European countries, financed by more tax increases; the other is for a leaner federal government, one where the government assumes the role of referee in the national economy. This very interesting debate will be a major part of the coming 2012 election cycle. At the heart of the matter, the US debt problem is a political issue. It will be resolved ultimately by the voters in coming years.

Technically Speaking

From a technical perspective, it is more difficult to find a good reason for the S&P downgrade. The US economy is very competitive, and holds key advantages in industries of the future, including technology, logistics, education, healthcare, transportation, financial management and agribusiness.

What is lacking are visible and viable policies for the country's future financial and regulatory situations. This lack of certainty has undoubtedly kept businesses, both here and abroad, from making further investments in either labor or machinery. This lack of stimulation in the economy is one thing that has S&P concerned. Regardless of the political outcome in 2012 and beyond, there must be a certain level of economic growth to significantly reduce the nation's debt, or at least make a significant dent in it.

As a result of a decided lack of policy clarity and no resolution forthcoming in the next few weeks or possibly months, markets which were open this weekend were erratic and volatile. Sunday night and into Monday morning, various news agencies were reporting international markets in Europe opening lower Monday, with the expectation the US market would also tumble. Not surprisingly, the slide downward on S&P 500 index futures at 9 AM today was about 2%, which is well within the normal daily volatility range of this index. Why is that? Because the markets have already priced the ratings downgrade and ensuing angst into equity prices. In fact, after the huge sell off last week most seasoned analysts and professional investors see this coming week having a number of great buying opportunities, and we agree.

So, where might the real investing problems lie? Actually, not with domestic firms with good balance sheets. An individual firm's stock price might be down, but for many, the underlying profitability and growth potential remains unchanged. As a result, equities may present buying opportunities. Real problems have surfaced for lower rated fixed securities in other countries and the US. The spread between top rated and junk bonds widened substantially in the past week, meaning investors are pricing junk bonds to have more risk. The same can be said of longer-maturity US bonds. Having said this, it is difficult to be precise about the movement of broad markets and certainly individual funds, sectors or industries.

Now What?

To keep things in perspective, S&P awarded the US the top AAA rating in 1941, some 70 years ago. The other sovereign credit rating agencies, Moody's and Fitch, have kept the US rating at AAA. Moody's awarded its top rating in 1914 and Fitch in 1973, when it first started rating US Treasuries. Again, S&P's downgrade points to a lack of coherent political policy, not a structural problem in the economy or business.

Having said that, your portfolio is designed with volatility in mind. Our rebalancing systems are poised to take advantages of the inevitable up and down movements in all the fixed income and equity categories – which may be greater in the coming months. Your securities include both foreign and domestic equities and fixed income components, which give us the ability to take advantage of strengths and weakness in the dollar and foreign currencies. Finally, your fixed income funds are invested in very short-term fixed income securities, with maturities as short as 1-2 years. These assets are designed to provide both stability and security, and that's just what they are now doing.

What we are doing is to diligently watch your assets and apply our oversight into adjusting your portfolio to take advantage of these swings. We will continue to manage risk, reduce volatility – and take advantage of it where we can – and look for increased returns as they become available. What we will not do is to jump to any conclusions, or liquidate positions unless forced by a personal financial emergency on your part. We do not consider this downgrade an emergency, but rather a necessary wake-up call to our federal government. Nearly 50 years ago, President

John Kennedy said *"There are risks and costs to a program of action. But, they are far less than the long-range risks and costs of comfortable inaction."* We hope and pray the "silver lining" in this event is a resolute effort on the part of Congress and the Administration to forge a program of action solving our debt issues which puts the US back on a path to economic prosperity. Thanks for reading these comments.

With my best personal regards,

Glenn