

Strategic Portfolio Adjustments

As we had written in November, bond insurers have been experiencing mark-to-market losses as a result of insurance written with respect to Collateralized Debt Obligations (CDOs). The CDO crisis has continued since that time to evolve and the insurers and many other major financial institutions have recorded enormous additional losses with respect to their CDO exposure. On Friday, Fitch Rating Service downgraded AMBAC Financial Group from AAA to AA. It is likely that the other rating agencies will follow with downgrades of AMBAC and MBIA as well. These are the two largest financial guarantors for municipal bonds. We have previously advised that the underlying credit quality of our client municipal bond portfolios were investment grade on their own without regard to the credit enhancement provided by the financial guarantors. We also advised that the average maturities of these client bond portfolios were short in duration. We are aware that the decline in credit rating may result in selling pressure which may cause such bonds to be carried at a lower market value. Nevertheless, for the above reasons, we are satisfied with our municipal portfolios as constituted and will continue to hold them.

As a result of bond insurer downgrades, we have a concern that longer-term bonds held by trusts that issue short-term variable rate demand note participations may experience a decline in value that causes the unwinding of such trusts. This could have implications for tax-exempt money market funds that have historically been the buyers of such short-term note participations. If these trusts were to be unwound, there could be a dislocation of capital that would put pressure on tax-exempt money funds. We are therefore reallocating client excess cash positions to Treasury money market funds. This reflects our paramount concern over creditworthiness and will necessarily result in a lesser after-tax yield than would be realized in a tax-exempt money market fund. This is a temporary measure in a time of particularly heightened short-term market risks. We will reevaluate our position on an ongoing basis.

On Monday, while the U.S. capital markets were closed for the Martin Luther King, Jr. holiday, international equity markets experienced a rapid decline. European capital market indices have now sustained year-to-date losses ranging from 10%-16%. Japan and India equity markets have declined year-to-date approximately 12%-14%, and China has declined year-to-date approximately 7%-8%. More than half of these year-to-date losses were realized by the markets on Monday. The triggering event to these declines appears to be the contagion of the U.S. subprime mortgage crisis and the related CDOs held worldwide by financial institutions and other investors. Pre-announcement from the China Central Bank and several European banks with regard to CDO/subprime losses was a likely contributing factor to Monday's decline. The other contributing factor was, of course, the increased likelihood of a U.S. recession that would impact our international trading partners. In response to this increased volatility and uncertainty, we will slow the process of investing in equities with new funds added to client portfolios, and in select instances may make a modest adjustment in equity allocations. Given market volatility, we believe this to be prudent.

The result of these two measures will be to temporarily build cash positions for most of our clients. As the capital markets progress through their cycles we will reevaluate on an ongoing basis. We are encouraged by the Fed's response of aggressively lowering interest rates Tuesday morning, and await an appropriate fiscal stimulus package. Based on our review of current corporate earnings, the outlook for corporate earnings, and our review of the performance of corporate earnings and equity markets in prior recessions and economic slowdowns, we understand that it is impossible to precisely time stock market turnarounds and rely on a more balanced approach to containing risk through a blending of high quality fixed income investments, cash and a diversified equity portfolio to best optimize the risk/reward balance.

We will continue to keep you apprised of important developments in the capital markets and our views and strategic adjustments. As always, personal client circumstances will affect portfolio structure. Please speak with your KLS managing director or director should you wish to discuss any of the above with respect to your individual portfolio.

January 22nd, 2008