

Horizon Notes

Industry Recognition for Horizon—We're pleased to report that Horizon has again been ranked as one of America's fastest growing investment advisors. We have been recognized by both *Wealth Manager Magazine* and *Financial Advisor Magazine* in their most recent issues. More details are included on our website.

Staff Notes—Allison Crosswell recently gave birth to her first child – a son, Miller on July 2nd. Mom and baby Miller are doing great and we're looking forward to having her back in the fall, after her maternity leave.

Construction Alert—Those of you who have been to our office in the past few months are all too familiar with the road construction on San Felipe. The contractors should be able to finish pretty quickly if the rain ever stops, but be sure to call if you're planning a visit so we can make you aware of any problems with getting in or out of the building.

Newsletter Distribution—Would you prefer to receive this newsletter by email? If so, please contact Cathy Haymes at chaymes@horizon-advisors.com or by phone at 713-343-3222 and we'll arrange for future issues to come via electronic format.

Thank you very much for your continued confidence in our services. We look forward to the coming years and continuing to work with our clients and friends.

Thoughts on Market Volatility

"If you can keep your head when all about you are losing theirs..."

The beginning of Rudyard Kipling's poem, *If*, seems an apropos beginning to our commentary this summer. After completing one of the best quarterly performances in many years, the markets have become pretty neurotic in the month of July. When the markets move up and down with breathtaking speed and all the news is concerned with fear and uncertainty, it's a good time to remind our-

selves that markets are volatile and that dramatic market price changes often have little connection to the intrinsic value of the companies that make up the markets.

We often talk about behavioral finance and the idea that investors, as a whole, are hard-wired to make irrational decisions, especially when they are fearful. This irrationality can become even more pronounced after long periods of steady, positive returns, such as we have enjoyed over the past year. As you will note in the following Market Review chart, the S&P 500 index has risen by more than 18% in the last year. Over the course of these sorts of steady, positive returns, folks (once again) begin to believe that "this time it's different" and that trees will really grow to the sky. These cheery outlooks can lead to overconfidence, which can easily be overwhelmed with the sorts of negative news we've been seeing recently. The Market Review section of the newsletter provides a more complete discussion of what's been happening and our opinions, but we don't believe that there is cause for alarm. We're just beginning to see some appropriate pricing and valuation adjustments in parts of the market which have experienced "Irrational Exuberance" lately. Following is a more detailed explanation of one of these market segments – sub-prime mortgages.

A Lesson in Risk Tolerance - Sub-Prime Mortgages

Recently, there has been a great deal of financial press coverage regarding the dismal failure of two hedge funds managed by Bear Stearns. The two funds, High-Grade Structured Credit Strategies Enhanced Leverage Fund and High-Grade Structured Credit Strategies Fund have recently become almost worthless, declining from a combined value of \$1.5 Billion in March of this year.

These funds had provided stellar returns for the past few years by investing in the riskiest portions of the "sub-prime" mortgage market. (The term "sub-prime mortgage" is a euphemism which describes the practice of lending to people who shouldn't be allowed to borrow.) The funds' investments in these riskier sections of the market provided larger returns in order to compensate

for the risk that those borrowers with shakier credit backgrounds are less likely to be able to pay their mortgages, resulting in delinquencies or defaults. To increase (or “amplify”) the returns even further, these funds also engaged in leverage or borrowing in order to invest in ever-larger amounts of these risky mortgages – reasoning that as long as the fund could borrow for less than the interest rates that mortgages were paying them, their returns would be increased further.

Unfortunately for the investors and Bear Stearns, the borrowing caught up with both the mortgagors and the hedge funds. Rising interest rates resulted in borrowers who could not pay their mortgage as well as higher borrowing costs to the firm on the money it borrowed to invest in the mortgages. As a spokesman for the firm noted, “the funds’ reported performance, in part, reflects the unprecedented declines in the valuations of a number of highly rated securities.”

There are signs that these “sub-prime” woes are expanding to other hedge funds as well. For example, the *Wall Street Journal* reports that an Australian hedge fund manager, also investing in sub-prime mortgages, has run into some difficulties, with two of its fixed income hedge funds down 14% and 9.2% in June. A spokesman for the funds indicated that the declines came after bond dealers abruptly marked down the value of the mortgage securities, noting that these securities were “otherwise fundamentally sound.” Fundamentally sound? That should be very comforting to the folks who saw the value of their investments decline so sharply in just one month!

The lesson? Chasing returns versus focusing on risk once again highlights this latest example of the triumph of greed over fear. Illiquidity coupled with leverage can be a recipe for disaster. The same sort of thing happened with Long Term Capital Management hedge fund in 1998 and Amaranth Advisors last fall. In fact, the unraveling of these investments and associated news may turn out to be the proverbial “straw that broke the camel’s back,” contributing to the recent market volatility.

COLLECTED THOUGHTS

“The greatest obstacle to progress is not ignorance but the illusion of knowledge” - Daniel Boorstin

Market Review

The following table shows market index returns for the 2nd quarter, trailing 12-months, and past 3 years.

Index	2nd Qtr	1-Year	3-Year
S&P 500 (Large Stocks)	5.81%	18.36%	31.78%
Russell 2000 (Small Stocks)	4.12%	15.05%	40.94%
EAFE (International Stocks)	5.34%	24.10%	70.35%
Lehman Bond Aggregate	-0.56%	6.66%	13.60%

Modest returns in the first quarter left many wondering if the financial markets were beginning the start of a long-awaited slow down. However, despite a weak June, the second quarter kept the bull market stampeding ahead to new all-time highs for many indexes. The first two months of the quarter charged ahead on upbeat earnings news and a flurry of corporate buyouts with the S&P rising a whopping 7.7%. June saw the Dow Jones Industrial Average bump up against the 14,000 level before inflation fears and continuing concerns about the sub-prime credit markets dragged the indexes down with the S&P 500 retreating -1.8%.

International equities continued their successful run and investment inflows to international investments continue to outpace all other categories. We continue to feel that international investments are an important component of our clients’ portfolios. However, we generally recommend managers that have the flexibility to seek returns in all corners of the globe and are savvy enough to know which markets to avoid.

The Federal Reserve remained quiet in the second quarter and kept the Fed Funds rate unchanged at 5.25%. Inflation fears have stirred, with headline inflation numbers coming in at 2.7% and core inflation rising by 2.2%. Both are slightly above the Federal Reserve target rate of 2%. Adding to inflation concerns is a tight labor market with the unemployment rate at 4.5%, which is well below the long-term average of 5.6%. Fed Chairman Ben Bernanke continues to remind the market that he will raise the Fed Funds rate, if it is necessary, to keep inflation close to the target rate.

As we discuss above, the most dramatic activity in the

second quarter took place in the normally unexciting bond market. Volatility was precipitated by the deterioration of mortgage-backed securities. The fallout from rising defaults in these mortgages has been focused primarily in a few hedge funds that were the eventual buyers of these loans. However, there is a great deal of anxiety in the market about how far the effects of this sub-prime collapse will spread.

Adding to these concerns are home values which have continued to soften as we enter the second year of home price declines. This trend will likely continue as many markets remain unaffordable to the average American and the sub-prime lending collapse has restricted the availability of loans to potential buyers. Markets on the west coast and in Florida have been hit especially hard.

The past 12 months have quietly and surprisingly brought amazing returns to investors in almost every asset class. The breadth of this rally has left everyone feeling good about their portfolios and the markets in general. We caution our clients to know that this has been an especially good time and it will not last forever. We now see equity valuations close to fair value and we think that the recent market turbulence will continue. The market reaction to a weak real estate market, sub-prime lending collapse, or possible rise in interest rates has the potential to remain uncomfortable. That said, we do not feel that the market is in a dangerous place or that near-term volatility would indicate an April 2000-style tipping point. Our plan in the face of volatility will be to aggressively rebalance portfolios and to remind our clients that investing is a marathon and not a sprint.

Thank you very much for your continued confidence in our service and advice. If you have any questions, comments, or would like to schedule some time to come by and review your goals and objectives, or to just visit, please call.

COLLECTED THOUGHTS

"The temptation to form premature theories upon insufficient data is the bane of our profession... It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts." - Sherlock Holmes, courtesy of A. Conan Doyle

Manager Spotlight— PIMCO Total Return Fund

We believe that bond investments, also known as fixed income, add stability and safety to our clients' portfolios. Bonds are typically less volatile than stocks and produce more income. However, high-quality bonds typically do not provide impressive returns to investors. That is why we believe the best strategy for our clients' bond investments relies on selecting fund managers who have proven over long periods of time that they can outperform the broader bond market.

With that in mind we have selected one of the legends of the bond market, Bill Gross, to invest some of the fixed income for our clients. Gross is considered by many to be the most savvy bond investor of our time. He is as recognized and esteemed in bond circles as Warren Buffett and Peter Lynch would be among stock enthusiasts. Gross has served as lead manager for the Total Return Fund for more than 20 years. According to the *Wall Street Journal*, the fund has an average annual return of 8.29% compared to 7.25% for the average intermediate bond fund.

Although Gross is the highest profile professional at the Newport Beach, CA based PIMCO, all of the funds are managed with a team oriented process. PIMCO's nine member investment committee, which is supported by one of the largest research staffs in the country, decide on economic and market themes from which they build their portfolios. They implement these themes using a strategy which relies heavily on derivative securities to position their funds. As PIMCO's results have indicated, they have successfully executed this process for more than two decades.

Adding to the talented team of advisors at PIMCO, former Federal Reserve Chairman Alan Greenspan recently agreed to an exclusive consulting deal with PIMCO. He has agreed to participate in the quarterly investment committee meeting and to share his opinions on economic trends and interest rate expectations. He will also be available to discuss various economic topics with the investment committee members at their request.

We have selected the PIMCO Total Return Fund for our clients because of their philosophy, skilled investment team, and long track record of superior returns. As with all of our recommended investment managers, we will

continue to monitor the performance and process of this fund to assure it delivers the quality and performance we expect for our clients.

Manager Update – Mainstay ICAP Select Equity Fund

On July 6th, NYLIM Mainstay announced that Robert Lyons, co-Portfolio Manager for the ICAP Select Equity Fund and ICAP CEO and CIO, has passed away at age 57. Over his distinguished career, Lyons truly set himself apart as a skilled investor and accomplished businessman. We have a great deal of respect for him and are deeply saddened by his loss. Our hearts go out to his family, friends, and colleagues.

Jerrold Senser, co-manager of the ICAP funds, will assume Lyons duties as CEO and CIO. Thomas Wentzel, who has been with ICAP for 15 years, will serve as co-portfolio manager. Despite the loss of Lyons, we feel confident that the ICAP Select Equity Fund is in good hands and have no plans to recommend a change in our clients' portfolios. However, we will continue to monitor this fund and will advise our clients if we feel a change in our recommendation is necessary.

Disclaimer: This manager (PIMCO Total Return Fund and Mainstay ICAP Select Equity Fund) is responsible for managing one or more investments recommended in the past by Horizon Advisors. A complete list of all investment recommendations Horizon Advisors has made in the past 12 months is available upon request.

COLLECTED THOUGHTS

"There is no inspiration in all the world like love." - W. Barclay

Making Cents

One of our clients is fond of correcting us when we use the phrase "if you die;" always reminding us that the operative term is not "if" but "WHEN." Our advice this quarter is to organize your personal and financial records in order to make things easier for your family at a time when such thoughtfulness is at a premium. We know from experience, that sorting things out after the death of a loved one can be frustrating and time-consuming and this additional burden comes on top of the emotional issues involved. So, before you go, let your family know where to find the following things:

- Your will – It's surprising how many people don't have one. Keep your will properly updated and maintain the signed original in a location with a trusted advisor.
- A list of all of your assets and important documents—Make sure you tell your family members and advisors where you keep your assets and important documents such as your bank accounts, investments, will, powers of attorney, insurance policies, deeds, important tax records, location of your safe deposit box, and where you keep the key.
- Instructions—What to do (and what not to do) if you're not there. If you handle all of the finances, make sure you've left instructions about what to do when you're gone. Your family will get the hang of things after a while, but some instruction about what to do in the short-term will be very helpful.
- A written list of your trusted advisors and their contact information.

If you would like help in addressing these items or getting organized, please give us a call.

Estate Planning

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