

## Horizon Notes

**Annual Report**—Each year at this time, we are pleased to give our clients and friends an update on our firm and its growth. Horizon Advisors and Maddox Thomson & Associates continue to be successful. We serve a growing number of clients and their families, helping to simplify their complicated financial issues by providing planning, investment management, accounting and administrative services.

As of the end of 2007, Horizon served 70 families with approximately \$130 Million in managed assets, including \$85 Million in discretionary accounts and \$45 Million in non-discretionary accounts.

Larry Maddox and Joe Thomson have each recently joined NAPFA, the National Association of Personal Financial Advisors. NAPFA is an organization formed to support comprehensive, fee-only financial advisors and the public. Members are required to strictly adhere to a fiduciary standard, which has been a hallmark of our advisory approach since we began Horizon Advisors.

In 2008, we welcome Suzanne Hatcher of Hatcher Public Relations and Marketing, who is joining us as a consultant. One of Suzanne's first projects will be to review our client survey process. She will begin contacting clients in the next few weeks to visit and to gather thoughts on their experience with the firm. Our ongoing client survey process has been helpful in identifying necessary steps to improve our processes and to add services which might be helpful to our clients. We'll report back on our performance and your suggestions.

Many thanks for your ongoing support and confidence in our services and for referring your friends and family to our firm.

## COLLECTED THOUGHTS

*"Sometimes when I consider what tremendous consequences come from little things, I am tempted to think there are no little things." - Bruce Barton*

## Keep it Simple

Investors have recently experienced one of the worst January markets ever. The financial news has made it clear that the seeds for this decline were sown over the past few years. In retrospect, 2007 may be remembered as the year that Wall Street outsmarted itself.

Increasingly complex financial products were created over the past few years to take advantage of low interest rates and strong credit markets. The structural changes in the financial markets encouraged so-called "financial engineering." New investment products encouraged investors and other market participants to become very short-term oriented, often borrowing on a short-term basis at very attractive rates and buying longer term instruments with only slightly higher yields. For several years, investors benefited from the status quo of a benign credit and interest rate environment.

Throughout this massive wave of credit expansion, managers struggled to understand the complexity and diversity of the risks created by these new products. At the same time, their firms made enormous profits from packaging and selling these products. One former hedge fund manager suggested that the large banks "violated Wall Street's unwritten "sausage" rule; that you sell this stuff to clients, but never own it yourself."

This was a sophisticated financial game of musical chairs and the music stopped when sub-prime borrowers began to have trouble making their payments, leading to the broad-based difficulties that we are now experiencing in the credit markets. This news, coupled with concern about corporate profits and the strength of the economy have created a whirlwind of anxiety and uncertainty. In addition, there is political and policy uncertainty associated with the upcoming presidential elections.

It looks as though an economic slowdown has occurred and a recession is possible, if not likely. It is also safe to assume that there will be further surprises in the financial arena as the market adjusts to further revelations about the extent of credit mistakes.

That said, we think there are a lot of reasons to be optimistic about equities. The U.S. financial system is not as fragile as the news media would have you believe:

- Stock valuations were reasonable when this downturn began and at this point are becoming even more reasonable as prices decline. This makes today's market a lot different than the 2000-2002 market, following the dot-com bubble.
- Interest rates are very low and are likely to be headed lower, which ordinarily stimulates liquidity, economic activity, and higher stock valuations.
- 4<sup>th</sup> quarter corporate earnings announcements so far have been generally better than expected.
- Unemployment at 4.9% remains well below the historic average of 5.6%.
- Oil and other commodities have come off their highs which should dampen inflation fears.
- Core CPI has remained comfortably within historic norms.
- The dollar seems to have found its footing and has been strengthening.
- A federal stimulus package has been approved and signed, which will put money back into the hands of U.S. consumers.

So, what's an investor to do? The first thing to remember is that investing is a long-term proposition and that there will inevitably be short-term, sometimes abrupt, changes in markets as the investing class swings from anxiety to exuberance. In spite of these behavioral predispositions and the short-term dislocations they create, the wise investor should continue with a disciplined, long-term investment strategy, based on their individual circumstances.

The recent unraveling of the complicated instruments mentioned earlier may yield a flight to simplicity. Distrust of complicated financial instruments and investing strategies may lead investors to favor simpler investments, such as bonds and common stocks, which can be better understood and managed.

The recent market volatility reminds us of the importance of creating appropriate portfolios for our clients and the particular risk of using new techniques. As we discussed in the last issue of our newsletter, we spend a great deal

of "behind the scenes" time evaluating our investment process and approach as well as other investment options available in the financial marketplace. While we are always looking for ways to improve our portfolios, we employ a slow, methodical, well-thought-out approach in our research.

We do not want to make any short-term decisions that are not in our clients' best interests. If further research leads us to recommend a change, we will let you know.

If you have questions or comments about your portfolio, please call and we'll be happy to review and discuss your circumstances.

### Market Review

The following table shows market index returns for the 4th quarter, trailing 12-months and past 3 years.

Index	4th Qtr	1-Year	3-Year
S&P 500 (Large Stocks)	-3.82%	3.53%	21.16%
Russell 2000 (Small Stocks)	-4.89%	-2.75%	17.57%
EAFE (International Stocks)	-2.04%	8.62%	48.69%
Lehman Bond Aggregate	3.24%	7.55%	15.60%

Although the fourth quarter was disappointing and volatile, 2007 finished generally for the better, leaving many hopeful that the New Year would bring a better outlook to the market and that its multi-year winning streak might continue through 2008.

Then came January and with it one of the worst three week starts the market has ever seen. At its low the year-to-date loss for many of the major market indices exceeded 11% and dipped below 15% from their peak in October. The panic that resulted in this fierce and indiscriminate selling was precipitated by a landslide of negative news which was amplified to deafening levels by the media. Doom and gloom headlines about recession, inflation, sub-prime loans, housing, employment, consumer spending, write-downs and the general health of our financial system had many investors desperately climbing over one another to reach the exits.

Then on January 22<sup>nd</sup> after overseas markets plunged the

day before and the US markets were poised to follow suit, the Federal Reserve abruptly and unexpectedly lowered the Fed funds rate by 0.75%. At their meeting the following week they lowered rates again by an additional 0.50%. This unprecedented decrease of the Fed Funds rate by 1.25% in less than two weeks time has helped the market find its footing and recover some of its loss. As of January 31<sup>st</sup>, the S&P 500 was down "only" 6% for the year.

In addition to the dramatic cut in interest rates, President Bush has signed an economic stimulus package that is designed to put money back into hands of U.S. consumers. The typical household can expect to receive \$600 - \$1,200 by early summer. Washington is hopeful that Americans will spend the money rather than save or pay-off debts. Considering the dismal current U.S. savings rate of (0.5%), it is likely that most of the stimulus package will be used for its intended purpose.

In contrast to the overwhelming negative sentiment, corporate earnings announcements for the fourth quarter have generally been better than expected, and recent economic data points have eased some of the fears that the U.S. is headed for a deep recession. Despite these hopeful signs, it is evident that the U.S. economy is experiencing a downturn. The depth and severity of this weakness is difficult to forecast although we think that most of the bad news has been priced into the market.

In the wake of this three month market slide, we feel that the market has become very undervalued. We believe that the market was fairly priced when this slide began in October and we now measure key valuation metrics at multi-decade lows. In particular, we are seeing a meaningful dislocation of stock valuations when compared to bond yields. Ordinarily, when bond yields are low, stock valuations are high and vice-versa. This is because an investor will typically choose stocks over bonds when bond yields are low and bonds over stocks when bond yields are high. Currently, bond yields and stock valuations are both very low with the expectation that yields could go even lower.

We expect market volatility to continue for the next three to six months, while revelations about losses relating to the credit crisis continue to surface and the outcome of the upcoming presidential election remains unclear. But

we are optimistic that the current valuation of the stock market is setting the stage for a substantial rally once all of the negativity has run its course and we begin to see some sunshine peak through the clouds that currently hover over Wall Street.

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.

### Manager Spotlight— The Jensen Portfolio

In a well-diversified portfolio, it is important to have many different asset classes as well as many different investment styles. In the design of our clients' portfolios we select a combination of managers, some of whom swing for the fences and others who focus on consistently getting on base.

Jensen Investment Management which is headquartered in Portland, Oregon does not try to hit home runs. The management team is more focused on not striking out. They specialize in buying extremely high-quality blue chip companies that have a long history of creating shareholder value. The fundamental hurdles they set for the companies they buy are so high that very few stocks are considered for the portfolio. This narrow universe of elite U.S. companies allows them to spend a great deal of time and resources analyzing and understanding the stocks they buy.

In bull markets, it is easy to take the contributions of a fund like Jensen's large cap growth portfolio for granted. Conservative portfolios like the Jensen Fund will often underperform and appear stodgy in high-flying up markets. But when the market begins to behave poorly, Jensen's prudent style reaffirms its merits by holding its ground much better than their peers.

Lead portfolio manager Robert Zagunis has been with Jensen Investment Management for 14 years and has over 30 years of experience in the financial industry. He has a bachelor's degree from Oregon State University and a Master's degree from the University of Delaware. He

supervises a research team that consists of two additional portfolio managers and four analysts.

We have selected the Jensen Portfolio for our clients because of their process, skilled investment team, and long track record of superior risk adjusted 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.

*Disclaimer: This manager (Jensen Investment Management) 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.*

## Making Cents

### Reading the Tea Leaves on Expected Changes to the Estate Tax

The Houston Estate and Financial Forum recently hosted Ron Aucutt, an experienced and very knowledgeable attorney, who practices in Washington D. C. Mr. Aucutt, who is a student of the estate and gift tax, as well as a student of the political process which creates the legal changes, made several very interesting points and we think makes a good case that we should expect some (at least interim) certainty in the future estate and gift tax scheme.

As a refresher to our readers, the current estate tax exemption is \$2 Million per person. This exemption is

scheduled to increase to \$3.5 Million in 2009. Then, in 2010, there is NO estate tax and finally, in 2011, the exemption returns to \$1 Million.

Our speaker suggested that his expectations are as follows:

- The complete exemption will not occur. Although there is substantial political support for an increase in the exemption, there is very little appetite for a total repeal of the estate tax.
- Congress will probably act in 2009 or 2010 and the effective date of any changes will not be before January 1, 2010. Given that 2008 is an election year, Congress will be in no hurry to act on the estate tax until its next session, beginning in 2009.
- Aucutt expects that the current law will continue through 2009, allowing the exemption amount to increase to \$3.5 Million. If Congress cannot complete work on a permanent replacement for the existing law, we should expect a multi-year extension of the law as of 2009.
- Finally, he expects that the exemption amount will settle between \$3.5 Million and \$5 Million and that it may be indexed for inflation, but expects continued suspense about the tax rates.

We will, of course, stay tuned to these continuing discussions and keep our readers up to date on any changes.

### COLLECTED THOUGHTS

*"To travel hopefully is a better thing than to arrive."  
- Robert Louis Stevenson*

Estate Planning

Tax Planning Services

Investment Management

Private Foundation Administration

**HORIZON**  
A D V I S O R S

5851 San Felipe  
Suite 700

Houston, Texas 77057  
713.748.7000

[www.horizon-advisors.com](http://www.horizon-advisors.com)

Financial Planning

Retirement Planning

Tax Compliance Services

Personal Financial Administration