SUMMER 2007

Kanaly Trust Investment Notes

Economic Overview

It was a year ago when the Federal Reserve last raised the target for short-term interest rates to 5.25%. Since that time, the US economy's growth has slowed from an average rate of 2.5% to 0.7%, inflation has dropped from 4.3% to 2.7% and unemployment rates have remained materially unchanged.

Moves by the Federal Reserve

We believe Federal Reserve Chairman Ben Bernanke's decision to 'pause' came at the right moment in time, and remaining

Communiqué

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committed to this pause is critical. The chairman's academic background and understanding of the Federal Reserve's tendency to create boom-bust cycles from shifting monetary policy will be tested as time progresses. History has shown repeatedly that the Fed has a reputation of raising rates too far, leading to spectacular market crashes. Conversely, spectacular crashes are an accumulation of Fed policy being too relaxed at the beginning of the monetary cycle fueling overly excessive market speculation. We have faith in Chairman Bernanke and believe he will continue to act as a beacon for global financial markets, remaining firm at 5.25%. This will allow market excesses to ebb and flow around his established mark.

Economic Drivers

The rise in energy costs has also played an important role in slowing economic growth. As energy prices rose, so did investment opportunities within the industry. A host of new inventions, alternatives and aggressive action to locate, produce and invest in new

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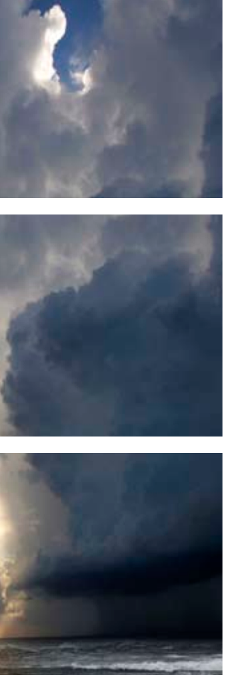

Sept. 8, 1900 was a day like any other in Galveston, Texas, or so it seemed to Isaac Cline, the chief resident meteorologist for the US Weather Bureau on the island. The winds that morning were peculiar and the cloud mass forming on the horizon was unique; even Cline, with his years of training and expertise, could not foresee the terror approaching. While it's not a hurricane out in the Gulf of Mexico, over 100 years later, it feels to us like some potentially dark clouds are forming as they relate to overall markets, possibly for the economy and certainly for investors.

Dark Clouds Forming On The Horizon?

Specifically, we refer to the recent coordinated and highly specific attack on private equity brought forth by Congressman Henry Waxman (D-CA). He proposed additional SEC scrutiny and oversight on the Blackstone IPO from late June and actually called for a halt to the IPO.

Couple that with the tax-based idea to eliminate the long-term capital gains rate treatment on the carried interest for private equity interest proposed by Sens. Chuck Grassley (R-IA) and Max Baucus (D-MT). They suggest converting that to more of a corporate income tax structure, all in the guise of trying to fund AMT tax relief.

This is troubling because it represents an overt effort by Washington, D.C. to impede the free flow of capital.

As you may know, we are staunch believers in supply-side economics and free markets. We believe that a reduction in the hurdles and impediments to capital flow is a good thing for markets and investors (and, along with it, the economy).

It's hard to imagine that the politicians in D.C. want to mess with a good thing. Consider the absolute vindication of supply-side economics since tax cuts were enacted in 2003.

At the same time tax rates were lowered, revenues hitting the Treasury's coffers increased in the following years – up 6 percent in 2004, 15 percent in 2005, 12 percent in 2006 and, so far in 2007, up an estimated 11 percent. Tax rates were reduced in 2003 and 2005, led by capital gains being reduced from 20 percent to 15 percent, dividends from 39.6 percent to 15 percent and marginal income tax rates from 39.6 percent to 35 percent at the highest levels.

We call that proof that capital flows freely along the path of least resistance to the overall long-term betterment of the markets and investors. In Washington they call it, quite literally, "unanticipated tax receipts."

We hope you would agree that all of this has spurred economic activity -- a desire by businesses to invest for appreciation and return. Free markets work. No matter how much spin other economic persuasions want to throw at the issue, both the economy and the federal government benefited from the reduction in tax rates. Capital has flowed to the markets and with it, investments were made and returns generated. Any impediments to this free flow can ultimately be harmful. Consider the overreaching implications of Sarbanes-Oxley.

Few would now disagree that as an effort to regulate corporate America in a post-Enron world, Sarbanes-Oxley, while potentially well-intentioned, was too far-reaching. Its impact created a disproportionate increase in foreign markets for newly minted stocks -- specifically as a source of IPOs -- when compared to domestic markets.

One only has to look at the interest many companies going public have in using London. New York is no longer considered the defacto choice, which ties directly back to the onerous provisions of Sarbanes-Oxley.

An assurance to the public that financial information being presented is accurate and complete is good. However, the markets have a way of taking care of those companies and sadly, investors along with it, which defies the public good.

Long before Sarbanes-Oxley and Enron, companies that fibbed on their finances became unwelcome at public exchanges and saw capital from investors dry up.

Take a look at what private equity is doing, no longer with relatively small and medium-sized companies, but with many of the biggest companies. One of the reasons private equity is enticing for public companies is to rid themselves of the regulatory and compliance burdens associated with Sarbanes-Oxley.

This is one of the few times in history where on a week-by-week basis large companies are either being taken private or are working in conjunction with private equity. All of this to move to the private side of the aisle for greater flexibility than available under Sarbanes-Oxley-imposed regulations.

As an aside, we note the irony in the Blackstone IPO. This is a firm that said it sought to free the companies it was buying from the costs and hardship of Sarbanes-Oxley compliance. But now it's willing to subject itself to those same compliance requirements so it can tap public markets for more liquidity to do deals.

That brings us back to the central question: If you believe that free markets work, do impediments – whether they are regulatory, taxation or government oversight – represent hard times ahead for free markets? We see the potential for storm clouds brewing.

We see it as evidenced by the recent debate where none of the Democratic presidential contenders – even if the election is a year and a half away – shrugged their shoulders or contested Sen. Hillary Rodham Clinton's (D-NY) statement that the Bush tax cuts have been a disaster – a "give-away to the rich." She also said that when they expire in 2010, there will be no attempt to extend them.

That's troubling – an increase in taxation is an all-too-common impediment to the free flow of capital. It restricts the ability for individuals to look to invest for a return. If you believe in supply-side economics, a potential increase in tax rates is not good for long-term market health.

This is not a Democrat or Republican issue. This is not politics; it is economics. For example, reduction of AMT tax treatment would be welcome in the view of supply-side economics. However, many leaders in both the house and the senate – Republican and Democrat alike – lean toward tax increases to offset their perceived loss in revenue from reduction or elimination of AMT rates. This is the aforementioned Grassley-Baucus idea.

We look at these dark clouds and wonder if they are merely a disturbance that will dissipate or will gain strength and support as they move closer to us in the years ahead.

We look at the sway of the general electorate and, although we cannot directly put our finger on it yet, something is definitely brewing.

For the better part of 25 years, the domestic economy, markets and investors have generally benefited from an overall policy of lower taxes. This has been true under both Democratic and Republican administrations.

So, be diligent in your belief that 2007 holds great promise for the markets; we are. We have question marks for 2008, however, as the political process heats up around national elections.

We will keep you posted as we monitor developments that might lead from the general disturbance we see now, into a tempest that could spell significant erosion in prospects for markets and investors.

With no intention of being an alarmist, we too do not want to look back through the crystal clear eyeglass of time and be judged to have been naïve as the economic storm's clouds began. Isaac Cline was asked years before the Great Galveston Hurricane to appraise the city's vulnerability and he said prophetically: "The opinion held by some—that Galveston at some time will be seriously damaged by some such disturbance (as a hurricane) is simply an absurd delusion." ●

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Andrew D. Kanaly David M. Doll

We have a new look!

Picture walking into your favorite restaurant, the one you always recommend to friends and enjoy on a special Saturday evening out. You have been visiting this restaurant for a very long time. The hostess knows you by name, the food is always good and the service top notch. But one Saturday evening you look around and realize that the wallpaper looks a little tired and the menu has been the same since the first day you visited. That Saturday evening experience is still a good one because that place holds so many fond memories, yet you would really like to see your favorite restaurant keep up with its competitors and continue to prosper.

Good business practice dictates that it was time to take a step back and evaluate our position in our marketplace. We asked ourselves, are we offering our clients all the services they need and want? Is our office a place where they feel comfortable and does it offer them the right experience when they come here?

To answer these questions, we decided to conduct a market research study. To begin with, we learned that our corporate identity, or appearance, is in need of a face lift – just like your favorite restaurant needs to update its dining room décor to stay in touch with its clientele. This gives them an atmosphere they will enjoy during a nice dinner out, adding to the overall experience of the evening.

We are beginning our cosmetic changes with this *Communiqué*. The *Communiqué* is taking on what we feel is a fresh a new look, and we hope to add more information to it that is helpful and interesting to you.

Our statements and letterhead will also look different when they arrive in your mailbox, and you will see that our logo and colors have changed.

Another improvement you will see from us is a new website, scheduled to come online in August. The new site will be tied in with the e-mails you receive from us periodically where we provide you an update regarding our thoughts for the markets and economy, as well as articles of interest.

The study is still in progress, and will guide us next in offering new and innovative services to serve you better. This will be a kind of menu re-work in the spirit of our restaurant analogy.

Even with the changes we are making, however, you should note that like your favorite old restaurant will always offer the best meal in town, we are committed to our core values and these will not change. The personal service we have always offered to you will still be there, as will the continuity – now and in the future.

Sincerely,

Andrew D. Kanaly — Chairman
David M. Doll — President & CEO

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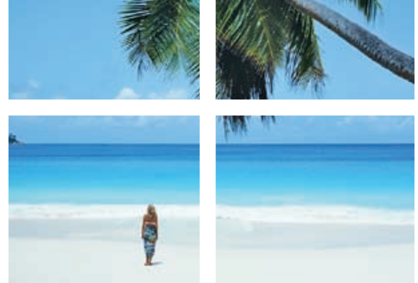


Summer Vacation Planning: A Retirement Preview?

Summer is here, and many families are planning and taking the perfect summer vacations. A location has been chosen, activities have been selected and money is set aside. For those on the cusp of retirement, a quick study of the vacation planning process and how you choose to experience your time off can provide a preview into their future retirement.

Proper planning equals a great vacation and a great retirement. Whether it's from personal experience or from hearing horror stories of poorly planned vacations from friends, it's easy to see that proper planning usually leads to a more enjoyable and successful vacation.

The same is true of your retirement. Sitting down with your spouse or financial advisor and creating a detailed retirement plan will put you on the road to an enjoyable retirement. Obviously, there are always a few unknowns, but if proper planning was completed, these bumps in the road will be easily weathered.

Set enough money aside.

Just like summer vacations, the comfort of your retirement very much depends on the amount of money you have set aside. So how much should you have saved up before you start your long vacation?

Each future retiree will likely have a different idea of what it takes to provide a comfortable retirement. With this in mind, a general rule of thumb assumes you can withdraw about 5% from your nest egg each year and manage to outlive your money. Therefore, if you would like to spend $100,000 each year of retirement you will need about $2,000,000 at the start of retirement. However, this is only a rule of thumb. Each situation is different and thus it is imperative you visit with your financial advisor to determine if you have adequate funds for your dream retirement.

Decide what will give you fulfillment.

There are many people who enjoy the idea of a summer vacation, but once they get to their destination, become restless or can't relax. While planning for a summer vacation mirrors retirement planning, it also can provide a preview into what retirement might be like.

When considering retirement, it is important to take into account your personality and what makes you feel fulfilled. For some, that means sitting around the house catching up on the latest TV craze. For others, it means continuing to work part time. For some, perhaps making a long-time hobby or passion into a lucrative new endeavor brings a sense of purpose.

No matter what it means for you, considering all aspects of your retirement will greatly increase the likelihood of an enjoyable experience. Your financial advisor can assist you in talking through your dreams and goals and guide you in making them happen. ●

The Deane Kanaly Memorial Golf Tournament

was held on April 24, 2007 at Blackhorse Golf Club. The winning team consisted of Tim Hartzell, Bob Barton, Barbara Files and Wray Parnell.

sources of energy has taken place. All this activity is leading to a growing supply of energy. Higher prices have also discouraged consumption by consumers. Historically, increases in investment and capacity have lead to lower pricing power. We believe in the not too distant future this mismatch of new supply into the market will decrease oil prices to the lower end of the $50 to high $70s per barrel range. As global demand assembles and tax incentives recede, oil markets will once again have an opportunity to appreciate. Higher prices will once again serve to determine the correct allocation of this politically controlled resource to the highest bidder.

Traditional engines of US growth such as manufacturing, auto production and housing have become underinvested and are outsourcing to cut costs. During the quiet of the night, Information Technology and Service Sector jobs are driving the US economy.

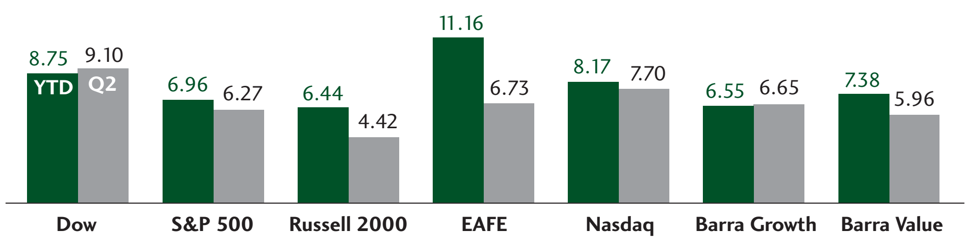
Inside the unemployment data, job growth in the healthcare and education sectors is amongst the strongest and steadiest. The next great American workforce is literally mind over matter. Aging demographics will continue to inflame immigration issues and legislation. Without careful consideration at this point, the future of production will oscillate between the similarities of an inflexible society in decline (like Japan) or the need to renew and accept the migrating worker to America and remain competitive within the global marketplace. By accepting the importance and openness of the migration of workers from around the world, America will reenact what it has for generations. To an economist, who envisions free trading markets as a solution, affording the opportunity of workers to stay located in local markets and not have to travel the world looking for work is a plausible solution.

Market Performance

During the second quarter of the year, equities rebounded strongly from a sluggish first quarter start. For the first half of the year, the S&P 500 increased 6.96%; International equities as measured by the EAFE Index are up 11.16%, the S&P 400 Mid Cap index is up 11.97% while the Russell 2000 Small Cap index is up *only* 6.44%.

Bond market returns have been volatile this year. As interest rates have increased 20-35 basis points (100 basis points equates to 1%), bond prices have dropped and cut into total return figures. Additionally, the shape of the taxable yield curve has reverted from being negatively sloped (short-term yields greater than longer-term rates) to a normally sloped positive yield curve. The total return for a bond is a combination of the underlying price change of the bond and the coupon interest earned during the period. As interest rates rise, bond prices drop inversely. Currently, the total return for the 10-year Treasury Bond is -0.33%. In the municipal bond market the slope of the yield curve has increased from 50 basis points to 118 basis points, as longer-term yields have risen. The total return for a 10-year Municipal bond is -0.86% year-to-date.

For the moment, money market yields remain relatively competitive to bond yields. However, as rates continue to rise, investing becomes more attractive. The trade-off of receiving a greater yield for higher risk is returning to the bond market.



Continuation of 2007 Investment Themes

We continue to believe the Federal Reserve will stay on the sidelines and hold short-term rates at 5.25%, allowing asset prices and lending practices to moderate around this established rate. We continue to see equity prices moving higher as the end of the year approaches; it has been a solid four-year run for stocks without a meaningful correction. We sense the next major move in equity prices will be sharp, so we are preparing to adjust your investments for this accordingly. For now, clouds of change are appearing. Larger-cap stocks with growth style characteristics are just starting

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to show signs of life. It is too early to make our rotation, but we will be viewing this shift in the coming quarters or year.

Our preferred investment in international equities has performed well. Over the very near future the relative out-performance may favor domestic stocks for a brief period, especially if global interest rates rise too quickly or the slowing US consumer dampens global growth. The wild card is to watch energy prices closely.

Longer term, higher American taxation and regulations on capital will diminish domestic returns in favor of international alternatives. The full effect of this will not come until the political season of 2008 and sunset provisions of 2010. Oil continues to stay within a range of $50 to the

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Spring 2007 Kanaly Distinguished Lecture

Dr. Arthur B. Laffer spoke at Kanaly's Spring 2007 Distinguished Lecture on March 6, 2007. Dr. Laffer served on President Reagan's Board of Economic Advisors, and is currently Kanaly's economist of counsel. Following is a summary of Dr. Laffer's talk.

Dr. Laffer talked about the areas of macroeconomics that are key to success in the United States and outlined their current status in the economy.

- First is fiscal policy, otherwise known as taxes. The United States has experienced substantial tax cuts over the years. It is difficult to believe that the marginal federal income tax was at 91% in 1961, and it is at 35% today. Taxes on equity/capital are also at the lowest rate in history.
- Next is monetary policy. The falling interest rates we have seen previously have led to the expansion of asset value, growth and prosperity. The long bond interest rate today is at 4.5%, resulting in no inflation in the U.S. economy.
- Income policies are the indirect ways the U.S. government affects businesses through regulations, restrictions, and policies. Union membership is at an all-time low, while minimum wage, relatively, is the lowest in 25 years.
- International Trade is also key to a successful economy. There are impediments of free trade across international boundaries. The U.S. is the only major developed country in the world with free trade, and has availed itself of the global community more than any other country.

According to Dr. Laffer, the market in oil is freer than it has ever been. Oil is so important to us for many reasons. It will be with us throughout long periods of time, and there is only one price for it worldwide.

As the price of oil goes up in the markets, people will find it too expensive, and will look for alternative methods and investments in new technologies, such as Ethanol.

As an economist, Dr. Laffer explained that the high oil prices we are currently seeing are a classic sign of markets working as they trigger substitution effects. It is his opinion, however, that within the coming one to two years, oil prices will dive down toward $30 per barrel, changing the world dramatically.

As a society, we will produce more and consume less. This will be due to the reduction of oil we import from the rest of the world as we see prices drop and our imports decrease. This will reduce our trade deficit dramatically, our supply of dollars in the world market will be contracted, the demand for U.S. investments will remain high, and the dollar will appreciate in foreign exchange. ●

high $70s per barrel, with the outside chance that a geopolitical event could lead to a spike above the high of $77.50. We believe that efforts to create available supplies of energy are producing positive results, which will ultimately provide lower prices. Our greatest long-term fear remains the excessive activity within the financial community. The advent of investment vehicles and the redistribution of risk is a wonderful thing as long as everyone is correctly pricing and accessing their risk tolerances. If some imbalance develops, the magnitude of off balance sheet counterparty agreements will expose potential imperfections causing a ripple that could include many new and untested global institutions and governments. The excesses of freely available credit from global sources like the Japanese carry trades or new hot money sources of capital in oil rich nations could unwind uncontrollably. History seems to repeat, but never exactly.

New Emerging Themes…

The Kanaly Board has empowered our investment process to engage a wider array of investment alternatives. The goal is to have greater distribution and participation in various asset classes, reducing the chance of being concentrated in any one single holding. By broadening our investments with greater diversification, risk will be spread across a wider range of assets. As long as these assets have a negative or uncorrelated return relationship, the concept of diversification will benefit the portfolio. To accomplish this directive we have started to add initial positions into Real Estate Investment Trusts (REITs) both domestically and internationally. We have added Small Cap exposures to client equity portfolios complementing our existing diversifiers in commodities and micro cap/private equity exposures. In the fixed income allocations we have begun allocating to high-yield bond funds to gain access to an additional asset class.

Mid Cap stocks have enjoyed a superior run in returns over the largest market capitalized companies since 1999, and smallest capitalized companies for over 20 years. However, these moves appear to be in their final phase. Mid Cap stocks mainly known for their stronger growth opportunities and concentration to defined markets have been popular targets of many large companies seeking to acquire better assets, market share or management skills. Large Cap stocks have used their excess cash flow aggressively to acquire these smaller players. Private equity managers and certain hedge fund managers, having watched this trend, have been active front runners seeking to restructure many of these companies before they are sold off or acquired in larger acquisitions.

Here is one final observation. The growth in the nation's money supply has owned our attention in the past. However, the lack of control has raised our interest into a short-term concern. The spread between two popular measurements, M1[1] and M2[2], has in our identification raised concern on the topic of how fast and free credit can be created. Our direct concern is how inflation can materialize from this expanding source of liquidity. If unchecked, we would like to see the Federal Reserve take the next step and actually raise rates as a last effort to discourage credit creation, but only as a last step measure. ●

1 M1 is the Federal Reserve's measure of a monetary aggregate and consists of the most liquid forms of money, namely currency and checkable deposits.
2 M2 is the Federal Reserve's measure of a monetary aggregate and consists of primarily household savings deposits, time deposits and retail money market mutual funds.

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