



# Kanaly Trust Investment Notes

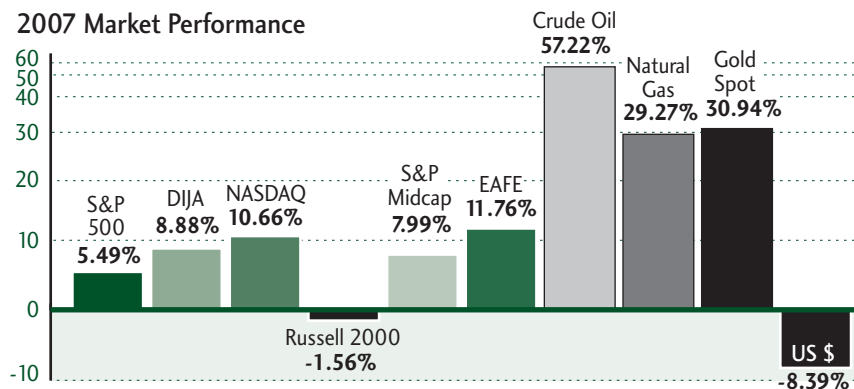
## 2007 Market Performance

Investors experienced a classic case of the tale of two markets in 2007. A continuation of the bull market early in the year gave way to fears of a recession and bear market as the holidays approached. In fact, the S&P 500 passed several milestones during the year, and achieved an all-time high of 1565 on October 9, 2007, a double-digit percentage gain through that date. However, a subsequent correction resulted in stocks limping into the new year with only a mid-single digit gain

# Communiqué

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for 2007. This performance significantly lagged the S&P 500's 15.8% return in 2006 and the 13% average over the past five years.



Through the first half of the year, strong earnings growth and a huge wave of corporate and private equity buyouts fueled the market's rise. For example, private equity firm Blackstone Group

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Early in your career, you may have looked at retirement readiness as an age. Mid-career, you likely started thinking about retirement in the context of amassing a certain amount of wealth as the measure of being ready for retirement.



by Jeff Kanaly  
Vice Chairman

## When Your Retirement Problem Has Nothing to Do with Money

As your career gets in the late innings, suddenly retirement preparedness comes down to your willingness to set aside what you've done for most of your adult life, and do something else.

The conventional wisdom that governed the traditional perception of retirement pegged life after your original vocation as living your "golden years," where days are spent putzing around the house and putting around the golf course. As we know, that has all changed with the baby boomer generation already making choices to retire differently than their parents.

For those of you who, like me, are in the baby boom generation, the reality is that retirement seems to come at a cost with which we are not entirely comfortable. Rather than being identified with the company or career that fostered a comfortable life and livelihood for your family, you are faced with the prospect of losing a sense of identity when you retire.

When financial security is a secondary concern as you assess your retirement readiness, you know that your retirement problem has nothing to do with money. It is for this precise reason that retirement for the coming generation will probably come in three phases, instead of one.

### Retirement Redefined: Stage One

Chances are, as you take a look at how you spend your time out of the office as you approach your retirement years, you may find that you've developed new skills or have culti-

vated new interests that will spur you to make the transition out of your day job.

This is the beginning of stage one of your retirement, and this is the time to research what you want to do with the rest of your life.

As you prepare to put your original vocation aside, you might find that you have ambition to become a business owner or to try your hand in a totally different work environment. Or, you may have a pent up desire to take on adventures and travel. Perhaps you might have a penchant for the arts or a desire to volunteer and give back to the community?

When an aspiring retiree comes to visit me in my office and lists all the things they want to do, these ideas come out. Then the conversation becomes as much about planning for what they want to do as it is about navigating the retirement issues that come with leaving their original career.

For many boomers, the reality is that stage one of retirement will actually be a time to redefine one's work day as opposed to giving up the work day altogether. Friends and family looking to spend more time with you might have to wait until stage two of retirement.

### Advanced Retirement: Stage Two

The liberating feeling that comes with having near-complete control over your time should help you evaluate when you are ready to set aside structured time commitments for other pursuits. In stage two of retirement, many boomers may find that their interests shift to

expressing themselves by way of spending time with family, cultivating their interest in music or art, or enjoying nature and seeing the world.

The second stage of retirement can and should be a fulfilling, rewarding transition in your life. You may be fully removed from your working life, but it doesn't mean it is time to stop making a valuable contribution to the world. You might utilize your time in one of the following ways:

- Find a pursuit that creates a new sense of identity. Personally, I'm a cyclist who supports multiple sclerosis research causes.
- Volunteer your time on a regular basis. Using a portion of your time to contribute to your community or support a favorite cause can give you the familiar camaraderie that you might have enjoyed in the workplace, pre-retirement.
- Commit to writing about your favorite memories, accomplishments and the values that have guided your life.

### Your Golden Years: Stage Three

Baby boomers will eventually want to focus on leisure and relaxation, and phasing into retirement will certainly make you ready to enjoy the conventional idea of the golden years. This is when a carefully constructed plan that takes into account the varied pursuits you want to engage in over your retirement becomes preeminently valuable.

As we face our own retirements, how we phase into this part of our lives is uniquely our choice. Unlike previous generations that were facing shorter life expectancies and a defined income stream delivered via the pension system, we baby boomers have the ability to freelance our way through the post-career era in our lives.

Certainly, this retirement "is not the same as your grandfather's." You want to do things differently and still enjoy your new world of retirement. We just need to embrace a new vision of retirement and plan for a new take on life after work. ●

## WHAT IS NEW FOR YOUR TAXES IN 2008?

As 2008 begins, it is again time to start thinking about squaring up with Uncle Sam on tax day. 2008 does not bring many changes for your tax filing, but here is a summary of the variations which will apply this year.

### Social Security

The wage limit, or Social Security maximum, was raised \$97,500 to \$102,000 – a 4.6% increase.

The maximum Social Security benefit was increased to \$2,185 per month for 2008, and the Cost of Living Adjustment (COLA) was defined as 2.3%.

### Deductions

The standard deduction amounts for 2008 include:

- Single - \$5,450
- Married filing separately - \$5,450
- Head of household - \$8,000
- Married taxpayers filing jointly/qualifying widow(er)s - \$10,900

The amount you are able to deduct for each exemption you claim on your federal income taxes was increased from \$3,400 in 2007 to \$3,500 in 2008.

### Retirement Plan Contribution Limits

For 2008, contribution limits for 401k and 403b plans are \$15,500 with catch-up contribution limits set at \$5,000. SIMPLE retirement plan limits are set at \$10,500 and catch-up contributions of \$2,500 are allowed. These limits all remained unchanged from 2007.

Income limits for contributions to Traditional IRAs and Roth IRAs, however, did increase in 2008. Income phase-out thresholds now start at \$159,000 for those filing a joint return and \$101,000 for single or head of household filings. The maximum for a Traditional or Roth IRA contribution increased from \$4,000 to \$5,000 for 2008. Filers who reach the age of 50 before the end of 2008 can contribute up to \$6,000.

### The Estate Tax

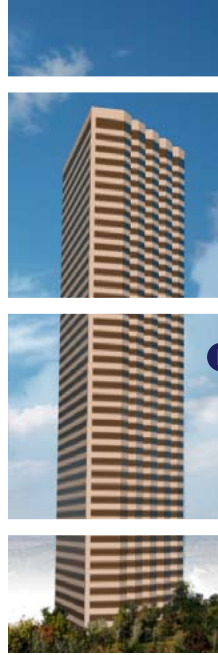
There are no changes to the Estate Tax exemption for 2008. In 2009, however, the exemption will elevate from \$2 million to \$3.5 million and the tax is set for complete repeal in 2010. If Congress does not extend the repeal, the exemption will return to \$1 million in 2011.

Source: money-zine.com

# We're Moving!

As we hope you read in our year-end letter, we had a busy 2007 at Kanaly Trust. You may have seen the paragraph about moving our offices to a new location and asked yourself, "Why change from the home I have enjoyed visiting for so many years?" Honestly, we have asked ourselves that very same question for longer than you know, and so we will explain.

Marathon Oil Tower  
Houston Texas



This coming July, we will move to the Marathon Oil Tower. The building is still located in the Galleria

area, and occupies the space on the corner of San Felipe and St. James Place. Our office entrance will be in the main lobby of the building, with staff offices on the 7th floor. We made this decision based upon meeting your needs as our client and providing you with the most proficient service available.

When you come to meet with us, we will use a brand new "conference center" on the Mezzanine (lobby) level and covered parking spaces will be reserved for you. Please be assured that although we will look more contemporary when you see our new space, our heritage will still be apparent.

So, bottom line, why the move?

Our current workspace was actually chosen by Deane Kanaly over 30 years ago. At that point, he only had a few employees and technology was limited. Since then, the requirements of our company, associates and clients have changed a great deal, and it is important for us to respond appropriately.

Technology is changing, as is our fast-paced global marketplace, and it is essential we keep up. With this move, we are able to build to suit our needs and yours, across the board.

The new building offers top-notch security services adding to the safety of our employees, visitors, property and proprietary systems/documentation.

Conference rooms will be much better suited for meeting with you and your family. Our new rooms will feature state of the art audio-visual technology, allowing us to review your personal portfolio and financial information in an interactive, visual presentation format when you come for your reviews.

Currently, our offices reside in two separate spaces on our building's first floor. This move will allow all of our associates to be in one collaborative area, and will give them a more efficient work space to serve your needs. The new office will also give us space for associate training and large company meetings, as well as options for the events we host for you.

Speaking of events, we plan to host an introductory affair to acquaint you with our new space. More details about that will follow. As always, we are here to respond to any questions or concerns you may have, so do not hesitate to call.

Sincerely,

Andrew D. Kanaly  
Chairman



David M. Doll  
President & CEO

# Kanaly Trust honors Stewart Family with Philanthropic Award

A donation of \$10,000 will be awarded to the Safe Space organization



Pictured with the award from left to right are Drew Kanaly, Douglass Stewart, Ginger Kanaly and Patty Stewart

At our annual Holiday party on Thursday, Dec. 6, we honored Douglass M. Stewart and his wife Patricia of Palm City, Fla., with the E. Deane Kanaly Philanthropic Award in recognition of their ongoing commitment and service to the community.

The E. Deane Kanaly Philanthropic Award was created to preserve the memory of the late Deane Kanaly, our founder and long-time philanthropist, by recognizing individuals who have made a substantial impact upon their community. The annual award is given to a client who displays a strong personal commitment to the betterment of society. A \$10,000 contribution to the honoree's charity of choice is included with the award, which will be given to the Safe Space organization.

Located in Martin County, Fla., Safe Space is an organization which provides emergency shelter for victims of domestic violence and their children. The Stewarts have spent their lives putting time and funds back into the community in a variety of ways including endless support and financial contributions for Safe Space.

Last December, the Stewarts saw an imme-

diately need for a new 24-bed shelter in Martin County to house abused women and children. Working with Safe Space management, community leaders, volunteers and architects, they established a matching gift media fundraising campaign. A year later, the construction of the new facility is nearing completion due to their determination.

Phillip Hamman, the Stewarts' firm contact at Kanaly, was honored upon hearing the news that his long-time friends and clients would receive this award.

"The Safe Space, as it is today, would not have existed if it were not for the vision, passion and hard work of this couple," Hamman said. "They have been an excellent example to all of us, showing that it does not matter what a person's age or status in life is, anyone can make a difference in their community."

Along with their generosity to the Safe Space organization, the Stewarts give seven scholarships to Oklahoma University every year, three of which are designated for Native Americans. They have also donated substantial funds to the Library Foundation of Martin County and the Martin Memorial Hospital Foundation. ●

bought real estate investment trust (REIT) Equity Office Properties for \$23 billion, which marked a peak for REIT valuations in 2007. Several private investment firms filed to go public, including Blackstone, Fortress Investments, and KKR. One executive proclaimed 2007 to be the “golden age of private equity.”

Then, almost on cue, the market environment did an about face. The sub-prime mortgage crisis, which had been building for months as the housing market deteriorated, burst on to center stage. The immediate result in the credit markets was a much greater awareness of risk and unwillingness to lend to all but the most creditworthy borrowers. Action by the Federal Reserve to provide relief was initially met with enthusiasm as the market rebounded to new highs. Soon after, however, large financial institutions including Citigroup, Merrill Lynch, Bank of America, and others began reporting multi-billion dollar write-downs of the mortgage-related assets, sparking the correction in stock prices.

2007 also marked a year in which a diversified portfolio among various asset classes enhanced returns. Large capitalization stocks trounced small cap stocks, reversing a trend that had been in place all decade. In similar fashion,

growth stocks significantly outperformed value, or out-of-favor, stocks by a wide margin. International stocks, led by emerging markets in China, India, and Brazil, continued to outperform U.S. stocks. Commodities, particularly crude oil and gold, posted excellent returns and the U.S. Dollar declined significantly against most major currencies.

Finally, the bond markets experienced a volatile year as well. In June, bond yields reached a five-year high with the 10-year U.S. Treasury bond at 5.25%. By year-end, amid the credit market turmoil and massive flight to quality, the 10-year bond had

fallen to 4.09%. On the short end of the yield curve, the 91-day Treasury bill fell nearly two percentage points to 3.32%.

## Economic Overview

The U.S. economy was resilient, and entered the housing crisis and resulting credit market turmoil with strong momentum. Gross domestic product rose at an annual rate of 4.9% in the third quarter, even though housing reduced growth by approximately 1%. The vast majority of the economy that was not housing-related grew nicely.

However, economic growth clearly downshifted during the fourth quarter as credit conditions worsened. Leading economic indicators, such as employment and consumer sentiment, have declined to the lowest level in over two years. Soaring food and energy prices continue to pinch consumers, and the housing market continues to struggle. Many economists predict slow growth in 2008 with the possibility of a mild recession.

We see two primary drivers of economic performance in the year ahead: consumer spending and action by the Federal Reserve. First, consumer spending is upwards of 70% of U.S. economic growth. For many years, some market pundits have called for the consumer to crack, but as long as employment continues to grow and personal income remains robust, the consumer is likely to surprise to the upside. We will be watching the employment situation closely in the months ahead.

The second major driver of growth will be monetary policy. The Fed has reduced short-term interest rates by 100 basis points, or 1%, since September. We believe the Fed has much further to go, and expect the Fed Funds rate to fall from the current 4.25% to around 3.00% by mid-year. The Fed has been reluctant to cut rates, presumably because of the threat of inflation. However, the Fed has maintained tight control over growth in the monetary base, suggesting that inflation should remain under control. Moreover, the bond market essentially demands more rate cuts, as the three-month Treasury bill yield is about 125 basis points below the Fed Funds rate. If the Fed aggressively cuts rates, a full blown credit



### Election Year Market Trivia Since 1900

When the incumbent party has lost a presidential election, the market's performance has been worse than the average of past election years.

In the 12 years the incumbent party lost, the S&P 500 gained just 1.6%, compared to the average 8.4% gain in all election years.

In the 17 years the incumbent party won, the S&P 500 gained 14%, and 18% when the winner was Republican.

Source: Ned Davis Research

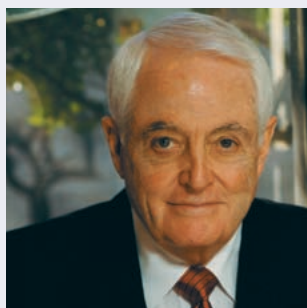
crunch should be avoided, allowing economic growth to accelerate.

### Investment Landscape Is Changing

The bull market that began in 2003 was supported by solid fundamentals including robust global economic growth, soaring corporate

earnings, and a strong appetite for risk. Capital was readily available for investments in all corners of the world as cash-rich investors sought attractive returns. Money could be borrowed cheaply, often under favorable terms, encouraging excessive risk-taking. These conditions created an environment that produced

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**E. Deane Kanaly**  
Kanaly Trust Founder

## American Heart Association Establishes Grant to Honor E. Deane Kanaly

Jeff and Drew Kanaly accepted a Distinguished Service Award on behalf of Deane Kanaly from the American Heart Association Northwest Harris County Division during their Sponsorship Kick-off Party on September 7, 2007. Pictured left to right: Lacy O'Connor, Jeff Kanaly, Drew Kanaly, Debbie Kanaly and Marilyn Carson.

The American Heart Association has chosen to honor the philanthropic legacy of E. Deane Kanaly by establishing a grant in his name.

The Kanaly family has supported the American Heart Association for decades. During his professional life, Deane served on the Board of Directors, Executive Committee and several working committees. "From the time my brothers and I were small, my father taught us about the importance of giving our time, talents and financial support to worthwhile philanthropic causes," Jeff Kanaly recalls. "Over his 76 years, he gave selflessly to so many causes personally and professionally. He encouraged his friends and associates to give, and during his long tenure as a financial planner, advised his clients to donate many millions," he continued. Jeff has followed in his father's footsteps, serving on the association's Board of the Northwest Harris County Division and on several working committees. He will be the Volunteer Honoree at this year's Heart Ball.

The Kanaly family has been committed through two generations in the mission of the American Heart Association, "to reduce death and disability from heart disease and stroke." These two illnesses continue to be the nation's number one and number three killers and are an on-going threat to our community and families.

Deane Kanaly's dedication to the cause has inspired the American Heart Association to honor his legacy with the E. Deane Kanaly Grant. The Kanaly family hopes that Deane's memory and the family's commitment to this worthy cause will inspire others to continue the cycle of giving to the life-saving research supported by the American Heart Association. To learn how you can contribute, visit <http://honor.americanheart.org/goto/kanaly>. ●

stellar returns for global equities, commodities, real estate, and many types of alternative investment vehicles.

We think the investment landscape is changing to a much more challenging environment. Credit market stress and commodity price inflation threaten global economic expansion and the bull market. The collapse of the housing and credit market bubble has reduced the appetite for risk-taking and sparked fears of a credit crunch. Risk is being re-priced upward, causing declines in asset values, and the equity markets are enduring a correction.

This change in the market environment calls for a cautious approach to investing in 2008, at least in the early part of the year. We expect high quality, large capitalization stocks in both domestic and foreign markets to outperform. Relatively defensive sectors such as energy, health care, and consumer staples are favored over cyclical stocks, financials, and consumer discretionary.

## 2008 Market Outlook

Our 2008 market outlook calls for a difficult trading environment into the second quarter, followed by a bottoming process and market recovery in the second half of the year. Market action is likely to be volatile, continuing a trend of higher volatility that began in 2007. Looking one year ahead, we expect stocks to finish at higher levels and outperform bonds.

During the first few months of the year, we expect the markets to focus on the economic slowdown and continued turmoil in the credit markets. Recent economic data, including leading indicators, employment, and manufac-

turing activity suggest the U.S. is on the brink of a recession. We should also expect banks to report additional asset write-downs tied to the mortgage crisis as the housing market continues to deteriorate, intensifying concerns of a credit crunch. Finally, the market will be vulnerable to earnings disappointments as the slowdown filters through corporate America. Volatility is likely to remain elevated until current uncertainties ease, including the extent of losses in the financial system, the depth of the economic slowdown, and the impact on overseas economies. This process will take some time to sort out.

The Federal Reserve, as well as central banks around the world, will face increasing pressure to ease monetary policy to stimulate the economy. In addition, President Bush will make an attempt to provide fiscal stimulus through tax cuts. The Fed has been reluctant to cut interest rates due to soaring commodity prices and the threat of accelerating inflation, yet inflation is likely to moderate with the economy brushing with recession.

Assuming the Fed comes to the rescue and aggressively cuts interest rates, equity markets should begin to rally around mid-year as the economy responds to global central bank stimulus. Attractive equity valuations and prospects for accelerating growth should allow stock prices to recover nicely, while bond yields rise significantly. ●



by James Shelton  
Chief Investment  
Officer

The information provided in the *Communiqué* represents Kanaly's broad investment-related views on the date it was published. Investment return information represents past performance and is not necessarily indicative of future results. Further, specific client portfolio investment returns and results may vary from figures noted in the *Communiqué* based on account-specific circumstances. Please contact your Kanaly professional to discuss any specific details of your account.



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