MARKET COMMENTARY **FIRST QUARTER 2008**

As you may notice, we changed the format of this commentary to make it more concise and readable. The order is also different, focusing on our outlook first and market performance last.

Outlook

We are witnessing the greatest uncertainty in the world's major capital market in our lifetimes. This may sound like the same message that we have expressed during the past two years; only now, the markets agree with us. Trailing twelve month earnings on the S&P 500 are about 17 times but the consensus forward earnings (as of two weeks ago) is about 14 times. If we examine the assumption underlying these projections, it assumes about 15% annual earnings growth, a heck of a feat during "normal" times. We are not in normal times. With earnings coming off several peak years of record profit margins and consumers bound by credit problems more severe than any time during the post WWII era, the probability of negative surprises is significant.

We are in a tug-of-war between the real economy and the financial system. Investors quickly move from euphoria to fear and vice versa. We believe that the biggest danger to the economy is a decline in loans to companies and consumers, as banks cut off the flow of credit to preserve their capital ratios. These ratios are intended to maintain a minimum level of capital to protect depositors against losses. The chairperson of the Federal Deposit Insurance Corporation recently said that credit downgrades may compromise bank capital ratios enough that some of the largest institutions will no longer be considered well capitalized. This could reinforce a brutal, self-sustaining downward cycle. A mild recession can quickly turn into a serious one.

We are concerned about commodity prices and their impact on industrial and consumer prices. Although there has been a recent correction in commodity prices, they are still at a multi-decade peak. In our opinion, the risk/reward (i.e. value) of owning pure commodities is being eroded, although it is clear that investors and speculators continue to buy on the dips. Corrections will be vicious.

We are still concerned about the real-estate and mortgage crisis, although we have been concerned about this for two years now. There is a growing supply of new and resale homes coupled with much tighter (although more prudent) mortgage lending standards. Even one of the few areas of real-estate strength, Manhattan, has experienced a reversal of fortune. Manhattan apartment sales plunged the most in 18 years in the first quarter. Sales fell 34% from a year earlier and inventory rose 4.6%. Construction spending in the U.S. fell in February for the fifth consecutive month. Building of private non-residential projects including office buildings declined for a third straight month.

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The International Monetary Fund (IMF) recently published its annual Global Financial Stability Report. It estimates that losses related to the U.S. mortgage crisis alone could reach one trillion dollars. Declining U.S. house prices and rising delinquencies could account for about $565 billion of these losses. These are estimates, but large estimates nevertheless. Banks and securities firms have set aside only $232 billion to cover such losses.

We agree with the IMF that "the current turmoil is more than simply a liquidity event, reflecting deep-seated balance-sheet fragilities and weak capital bases, which means its effects are likely to be broader, deeper and more protracted." The IMF stated early in April that they estimate a 25% chance of a world financial recession (meaning a 3% growth rate, akin to year 2001). The world economy is slowing and will be very different from the one consumers and investors have become accustomed to during the past several years.

The IMF report continues to note that while "risks to financial stability remain elevated" worldwide, emerging market economies "have been broadly resilient." However, "Further downward pressure on the [U.S.] dollar, particularly if it… [comes] from subprime or similar shocks, could boost liquidity and lead to an intensification of inflationary pressures in some emerging markets." This is because many emerging economies are linked to the U.S. dollar. The IMF predicts China to grow 9.3% this year, down from the 10% projection made in January. The Asian Development Bank today lowered its forecasts for Asia, and said central banks in the region will pursue policies to control inflation rather than promote economic growth. The World Bank also warned of the threat of rising energy and food prices. Growth in Asia ex-Japan will be 7.6% this year. This contrasts with the Japanese economy growing at a disappointing 1.4% for this year.

This is not to say that all is gloomy. Manufacturing in the U.S. contracted less than forecast in March, easing concern that less consumer spending and business investment will cause a deeper economic slump. Exports, supported by a weak U.S. dollar, are helping sustain U.S. factories as domestic demand falls. In fact, domestic airplane and aviation parts manufacturers are not forecasting a slowdown in global demand. Perhaps in the long-term, a strong U.S. dollar is in the best interests of this country, but domestic exporters would strongly disagree in the short-term.

We are inclined to believe Fed Chairman Bernanke in his recent testimony before Congress, "It now appears likely that real gross domestic product will not grow much, if at all, over the first half of 2008 and could even contract slightly." He continued, "Monetary and fiscal policies … will help to promote growth over time and to mitigate the risks to economic activity."

The U.S. Federal Reserve is attempting to mitigate the financial distress that is being caused by a realization that there are structural problems in the pricing of certain financial securities. The underlying problem is that there has been no process for determining the true market value of securities that are not trading. We believe that most financial institutions would rather have the true price discovery process be delayed on many of the esoteric financial securities. They are fearful that a few transactions instigated by forced liquidation would set the new price of a given asset type such that their firms would be rendered insolvent. Until these assets are traded, this financial mess cannot be resolved. In our opinion, the Fed is delaying this re-pricing process in the hope that there will not be a stampede to the exit doors.

The combination of massive monetary easing and increasing fiscal stimuli along with major government intervention could be enough to stem the slide over the next several quarters. The expectation of the Wall Street firms is that the worst is over. This expectation could be a risky operating assumption.

Capital preservation approaches that have worked during past stressful market periods, such as a major commitment to cash and high-quality short-term instruments, may not be sufficient. Higher rates of inflation could ignite a rush out of fixed-income assets and a surge into commodity-based or asset-based equities as bond prices plummet. With prevailing interest rates on 10-year U.S. treasury notes at about 3.5% and the prospects for stocks still in the single digits, it will be very difficult for a mix of traditional stocks and bonds to provide a return exceeding 5% for the next several years. This is why we continue to investigate (and invest in) more non-traditional sectors and assets.

Client Portfolios
There are times when it is profitable to be early in building equity exposure. There are times when it is best to be late (our current posture). The case for being early is that markets can spike up suddenly after a sell-off and those who are late miss out on a good portion of the potential gains. At the other extreme, being early can mean suffering the final painful sell-off that often comes near the end of a bear market. During the quarter, we considerably lowered equity exposure in most portfolios.

Most clients are now invested at half of their equity neutral policy. We sold off the full position in Pacific ex-Japan and unwound the paired trade of domestic Large-cap Growth and short Russell 2000. The resulting cash was reinvested into an existing short-duration, high-quality government bond position.

On the domestic equity side, the major exposure is in specific sectors: Technology, Utilities, Global Telecommunications and Global Healthcare. To a lesser extent, most clients also have exposure to Energy and Basic Materials. We are concerned about the lack of price support in the Telecommunications sector and are evaluating whether this is still a prudent investment.

On the international equity side, most clients have exposure to Germany. The economic conditions in the euro-zone are as confusing as in the U.S. Although the euro area is measuring headline inflation at an uncomfortable rate of 3.3%, the core rate is around 1.8%. Similar to the U.S., energy and food prices are large contributors to the rising inflation rate.

We continue to monitor emerging markets, especially in Asia, for an opportunity to invest. However, this is still a complex and volatile region. The historically successful policy used by Asian governments to fight overcapacity (undervalued currencies) does not look very attractive going forward. A large buildup of foreign exchange reserves is creating excessive liquidity and a need for more sovereign wealth funds. China has allowed for the strengthening of the local currency, about 4% in the first quarter alone. Inflation is beginning to increase, albeit from low levels. Some of this inflation will be passed along to the American consumer in the form of higher prices for imported goods.

What does all of this mean for client portfolios? We are not convinced that there has been the capitulation that will mark the bottom in equity prices. This is a time for extreme patience. We prefer to wait out the current turmoil before recommitting capital.

We usually detail composite client performance in the appendix. For compliance reasons, we have decided to omit these composites. Clients will continue to receive their actual performance results in a separate report.

Market Highlights
It was a terrible quarter for equities across the globe. The massive asset deleveraging that began in January 2008 continued (at a slower pace) into February and March. In the United States, the S&P 500 was down 9.5% for the quarter. Specific industries suffered even more. Financials were down 14.7%, Technology down 15.4% and Telecommunications down 14.6%. Transportation, a normally cyclical and leading indicator industry, was up 5.2%. Furthermore, U.S. REITs were up 1.4% (mostly on March performance). Outside the United States, developed Europe was down 9.2%, Japan was down 8.6% and Pacific ex-Japan was down 13.7%. Emerging markets were down 11.3%.

For American bonds, the Lehman Aggregate Bond Index was up 2.2% for the quarter. Municipal bonds were down 0.6% for the quarter, after a large 4.6% loss in February. Inflation-protected bonds were up 1.8% for the quarter, a meager performance after a strong 2007. Globally, bonds performed well. In U.S. dollar terms, quarterly performance across Europe was up 8.8%, in Asia-Pacific, up 12.2%. Inflation-protected bonds in the U.K. were up 11.7% for the quarter, similar to inflation-protected bonds in Sweden, France and Germany. Clearly, inflation is a concern across Europe, too.

In a second consecutive decline, corporate profits dropped 3.3% in the fourth quarter from the previous three months. Corporate capital expenditures for durable goods has dropped in the first two months in 2008. Industrial production dropped a greater-than-forecast 0.5% in February although it rose 0.3% in March. Consumer spending has been stagnant since last December. According to a March Bloomberg survey, the domestic economy grew at a 0.1% pace in the first quarter, following a 0.6% growth in the fourth quarter of 2007. We are in a recession.

It was an unprecedented quarter for U.S. Federal Reserve policy. It invoked a rarely used authority to provide emergency financing for investment banks and quickly brokered a deal to bail out counterparties of Bear Stearns. Several Fed board members were promoting aggressive easing. In fact, a total rate reduction of 2% in this quarter alone is the fastest drop in two decades. In an attempt to add some stability to the money market system (which imploded in a chaotic mess), the Fed added several hundred *billion* in liquidity to commercial banks and primary dealers.

We usually detail index performance in the appendix. In the interest of brevity, we have decided to omit this section. Clients will continue to receive index performance in a separate report.

Concluding Thoughts
We thank you for your support and confidence in Advocate.

We recognize that our clients have given us an important responsibility to manage their assets. We take this charge very seriously. Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook in greater detail.

April 16, 2008