

DISCIPLINED INVESTING

NEWSLETTER

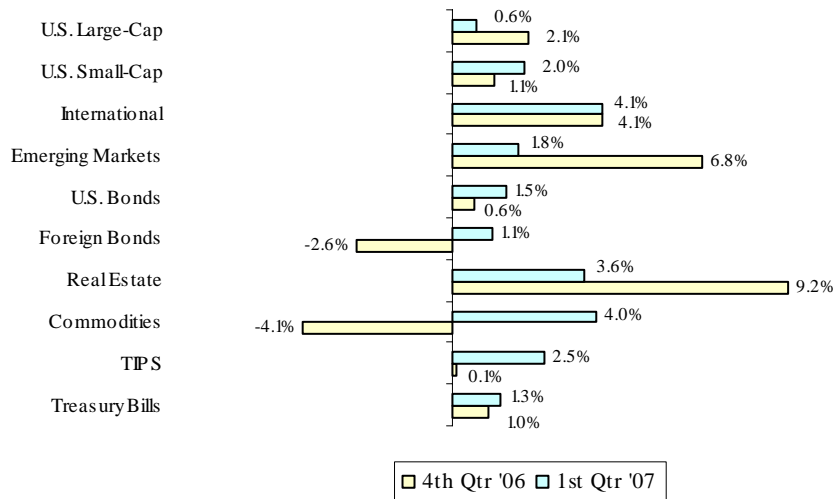
MARCH 31, 2007

MARKET UP-DATE

Despite some erratic swings in the global stock markets, the 1st quarter ended with about every investment category (asset class) in positive territory. However, gains were modest – the US stock market as measured by the S&P 500 is up only slightly, about .6%; the US bond markets are up a little more, about 1.5%; International stocks continued to lead the way, gaining 4.08%.

Looking forward, the stock market will continue to be fickle. The economy in general and the housing market in particular appear to be softening. On the upside, inflation still seems to be tame, interest rates remain stable, and the economy continues to grow, although at a slower pace. Personal investors should keep their portfolios positioned with a mixture of different investments structured to lessen risks in uncertain markets such as we have had so far this year.

For additional charts and information about the previous quarter, please visit our website and see our Quarterly Review & Outlook in the Archive section.



INDEX SCORE-CARD

QUARTERLY RETURNS

S&P 500:	0.64%
Russell 2000:	1.95%
Lehman Aggr.:	1.5%
MSCI EAFE:	4.08%
Wilshire REIT:	3.62%
Commodities:	3.95%

All data as of the period ending
3/31/07

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WIT & WISDOM

"You got to be careful if you don't know where
you're going, because you might not get there."

- Yogi Berra

QUARTERLY TOPIC: REAL ESTATE—TIME FOR A DEEP BREATH

Everything has a cycle. The past few months have brought significant and definitive indications that the boom in residential real estate prices has come to an end. With the end of the boom comes both the revelation of a scandal and worry that declining home prices will lead to recession. Inflated expectations, aggressive investment, and eventual price declines & scandal are the classic signs of an asset price bubble & bust. Now is a good time to take a deep breath, review what is going on, and re-evaluate the relative attractiveness and reasons for owning real estate.

The evidence that real estate prices are cooling are all around us. The price of new homes fell 10% in the 4th quarter of 2006, existing home sales are slowing, and publicly traded home builders have issued gloomy market outlooks. Pockets of strength remain, but overall the housing market has definitely cooled off. In addition to this natural cooling, a dark cloud hangs over the mortgage industry. Sub-prime lenders, the bankers and brokers who lend money to people with bad credit, are being investigated for predatory lending and fraud. The true economic impact of the sub-primes won't be know for a number of months. The more immediate damage stems from a general potential loss of confidence in the real estate market and those who are supposed to facilitate transactions.

Whether a cooling real estate market and troubled sub-prime lenders will send the economy into recession is an open question. The good news is interest rates are still very low, growth in personal income continues, and the job market is tight with unemployment at around 4.5%. Home values are generally tied to these factors. The problem might be that values have far over-shot income and need to come back to the average. In addition, any sign that inflation is a threat and the Federal Reserve will have to think seriously about raising short term interest rates. Thus, the economic outlook is rather ambiguous.

Of greater importance is for buyers to understand one thing – a home can be an excellent purchase due to the quality of life gained, not due to any inherent advantage it holds over other potential investments. From 1963 through 2006 the price of new homes has risen at an annual rate of 5.9% per year, little more than ultra-safe Treasury bills. In terms of real returns (after inflation), stocks significantly out-performed real estate of the same time period...5.95% versus 1.35%. Unfortunately, the human tendency is to put undue weight on recent history and extrapolate that into the future. A few years of blockbuster home price appreciation has lead to skewed and unrealistic expectations. Stocks experienced the same phenomenon in the 1990's.

In addition to the poor relative rates of return, home ownership is expensive, and the costs are often underestimated. Annual maintenance costs have been estimated to run approximately 1% of the value of a home. Throw in property taxes, home-owners insurance, and the occasional major repair (such as a new roof) and the actual return to home equity diminishes rapidly. As the Wall Street Journal's Jonathon Clements states it, "you aren't investing in real estate – you're consuming it."

We are now at a point where prices are more likely to decline or moderate than rise by double-digit rates. Inflection points such as these are disruptive. They expose people who have over-extended themselves financially and/or have preyed upon those caught up in the mania. Once the hype subsides, homes will remain a viable asset to own due to both the tangible benefits – tax deductions and price appreciation, and intangible benefits – stability, security, and pride of ownership. Fortunately, everything has a cycle.

Regards,
Brian J Lawrence, CFA

Index Definitions

S&P 500: A U.S. large company stock index. A group of 500 of the most widely traded stocks in the U.S., as selected by Standard & Poors.

Russell 2000: A U.S. small company stock index. The smallest 2000 stocks in the Russell 3000 Market Index.

Lehman Aggregate Bond: A total bond market index, including corporate, government, mortgage and asset backed securities.

MSCI EAFE: An index of foreign stocks in the developed markets of Europe, Australia, Asia and the Far East.

Wilshire REIT: A composite of Real Estate Investment Trust traded on the U.S. stock exchanges.

Commodities: Performance is represented by the PIMCO Commodity Real Return Strategy Fund, which uses the DJ AIG Commodity Index as a benchmark.

TIPS: Treasury issued bonds whose principal value is indexed to the CPI, thus rising and falling with inflation.

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