Headwater Investment Consulting, Inc.

Quarterly Review & Outlook

4th Quarter 2007

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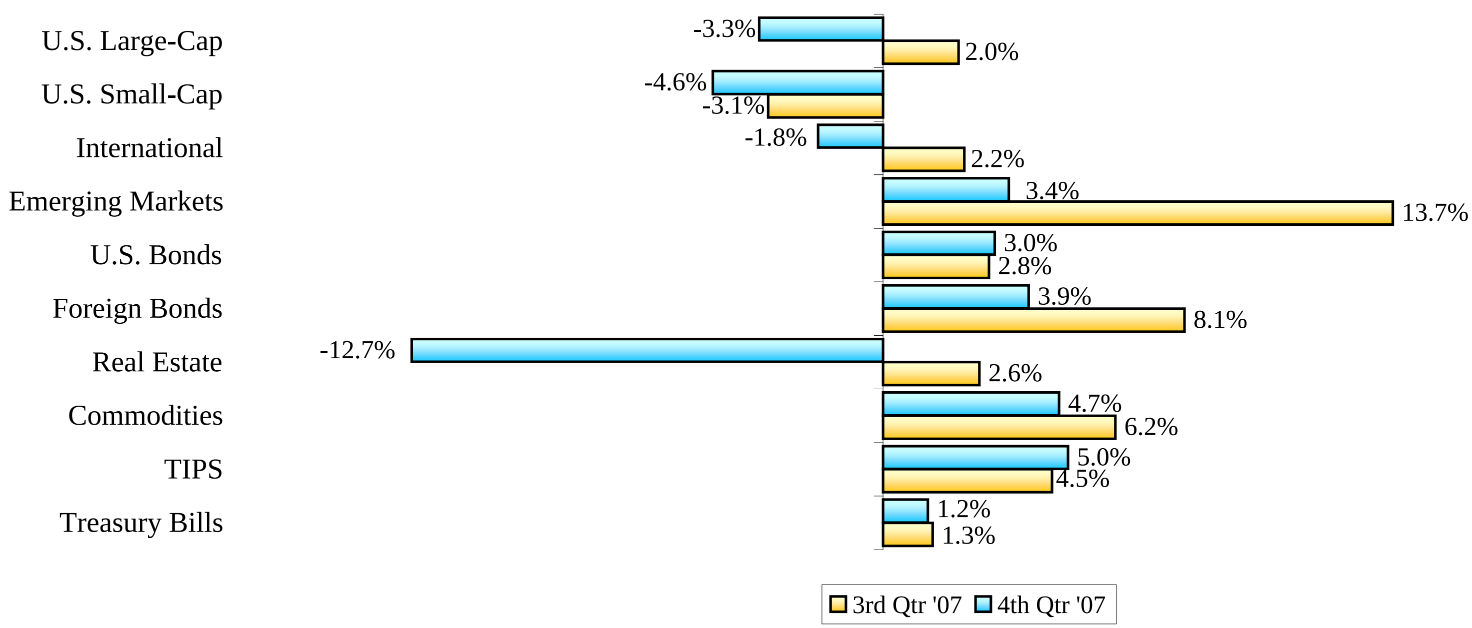
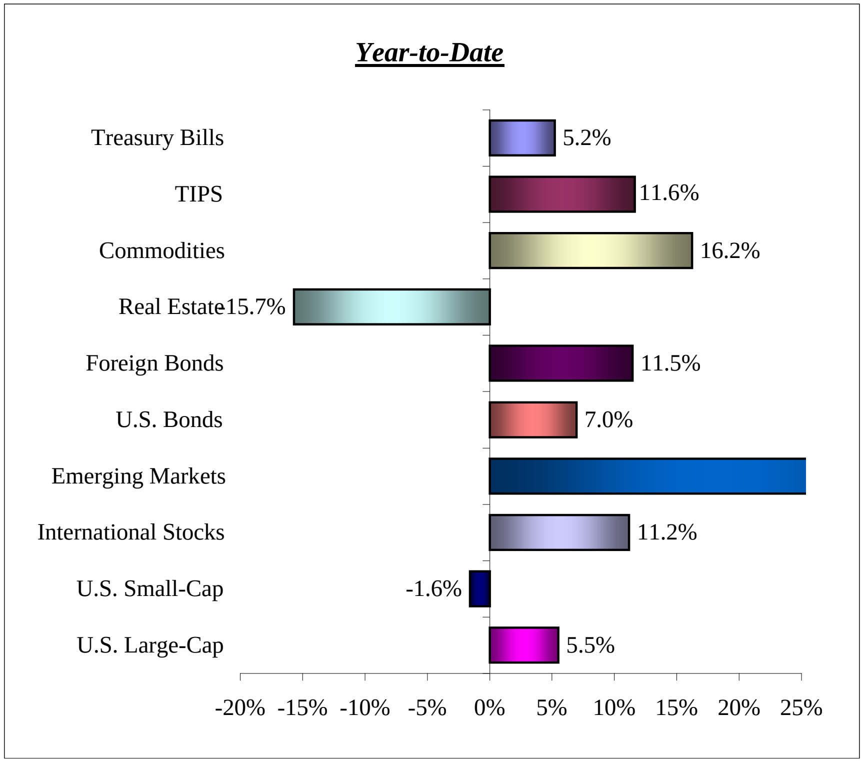
MARKET UP-DATE

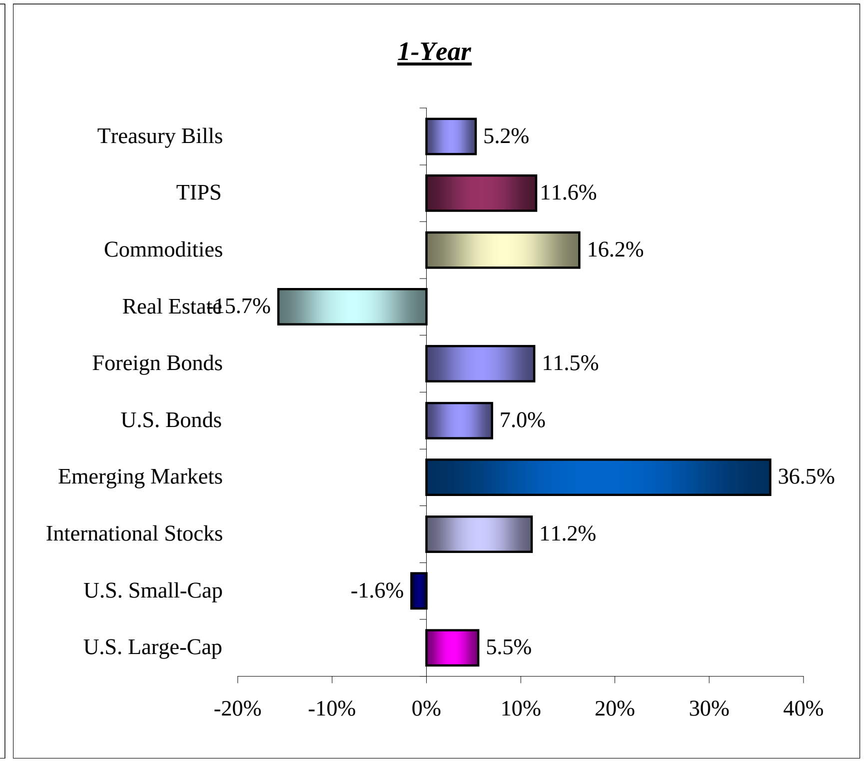
Stocks & bonds ended 2007 with moderate returns in spite of turmoil in the latter part of the year. Subprime mortgage defaults, a housing slowdown, and concerns about a slowing economy were the primary sources of anxiety. The S&P 500 stock index was up over 5% for the year and the Lehman Aggregate bond index gained approximately 7%. On the flip side, smallcap stocks eked out a 1% gain, real estate investments (REITs) lost in the neighborhood of -16%, and value stocks performed poorly after a string of good years.

Performance leaders from the previous three years saw a reversal of fortune and volatility became common place. The beginning of 2008 has brought with it more wild swings in the market. Uncertainty about the economy abounds, thus we expect more of the same. Times like these challenge investors' dedication to their principles. Falling stock markets lend the concept of market timing a bit of luster. However, it is undeserved. Markets fall and then reverse course rapidly and without warning. Economic slow-downs and, dare we say it, recession, are temporary conditions. A long-term plan takes these into account and disciplined investors ride through stormy waters, adding more to investments that decline sharply in value.



ASSET CLASS PERFORMANCE





Index Performance as of: 12/31/2007

	YTD	1 Mo	3 Mo	1-yr	3-yr	5-yr	10-yr
U.S. Large-Cap	5.5%	-0.7%	-3.3%	5.5%	8.6%	12.8%	5.9%
U.S. Small-Cap	-1.6%	-0.1%	-4.6%	-1.6%	6.8%	16.3%	7.1%
International Stocks	11.2%	-2.3%	-1.8%	11.2%	16.8%	21.6%	8.7%
Emerging Markets	36.5%	0.3%	3.4%	36.5%	32.0%	33.7%	11.7%
U.S. Bonds	7.0%	0.3%	3.0%	7.0%	4.6%	4.4%	6.0%
Foreign Bonds	11.5%	-0.7%	3.9%	11.5%	2.7%	7.5%	6.3%
Real Estate	-15.7%	-5.0%	-12.7%	-15.7%	8.5%	18.2%	10.5%
Commodities	16.2%	4.6%	4.7%	16.2%	12.9%	14.3%	9.0%
TIPS	11.6%	-0.2%	5.0%	11.6%	4.9%	6.3%	7.5%
Treasury Bills	5.2%	0.4%	1.2%	5.2%	4.7%	3.3%	3.9%

QUARTERLY TOPIC: A RISK OF MILD STAGFLATION

As the U.S. economy slows and signs of inflation persist, a term from the 1970's, stagflation, is making like bellbottom pants and reappearing when you are in no mood for disco fever. Stagflation was used to describe the era of stagnant economic growth and high inflation. Every era is different, but enough similarities have appeared for economists to reminisce about a time when oil embargos shocked the world and polyester pants where fashionable.

On the economic front, the economy has un-deniably slowed, but policy-makers are using all available tools to counteract the momentum and try to reverse it. Interest rates have been dramatically slashed. An economic stimulus plan will soon be passed by Congress. The effectiveness and timing of both actions are hotly debated, but they will likely add a spark to the economy. To some extent, we are working through a natural economic cycle and patience is the only attribute that will be of any use.

Slowing economic growth is typically accompanied by declining inflation, but today we have not yet seen that occur. A 4.1% gain in the CPI last year was the largest rise in the last 10 years, if not longer. Many factors are at work. Commodity inflation is persistent, sources of deflation may be disappearing, and monetary policy is explicitly inflationary.

Commodity inflation is being driven at the margin by booming emerging markets, especially China and India. According to the London Times, "China is already the world's largest consumer of every big resource except oil and accounts for 47 percent of all iron ore, 32 percent of aluminum, and 25 percent of copper." In addition, the rising middle class of these countries have evolving tastes. Higher standards of living are generally accompanied by consumption of more protein, a possible source of demand and inflation for meat, milk, and feed-grain prices. Furthermore, energy-producing nations have become very comfortable with high oil prices. OPEC is in fact considering a cut to production to head off any decline in demand if the U.S. economy softens more than expected. As a result, energy and other commodity prices could remain stubbornly high.

These sources of inflation did not appear over-night and have in the past decade been at least partially compensated for by a powerful deflationary force – China. This could be changing. Annual inflation clocked in at a 6.5% in August of last year, the highest rate China has experienced in the last 10 years. There is concern among economists, including the former Federal Reserve Chairman Alan Greenspan, that the addition of millions of Chinese and Indian workers to the global labor force was a one-time phenomenon that contributed to an era of low inflation. As that era phases out, a past source of deflation or low inflation may transition to something less benign.

Finally, Federal Reserve monetary policy has the potential to exacerbate inflationary pressures. Deep interest rates cuts were recently made to ward off recession. Low rates in the U.S. make dollar denominated investments relatively less attractive to foreigners. Thus capital may flow out of the U.S., resulting in a further decline in the value of the dollar. A falling dollar makes all imported goods more expensive and therefore causes inflation. Low rates can have other repercussions that lead to inflation, which puts the Fed in a tough spot – they want to stimulate the economy with an "easy money" policy, but inflation is a very destructive force, especially for those on fixed incomes.

Of course, common sense and history tell us there are two sides to every story. Prior to the last two recessions, inflation behaved in a similar fashion, rising to a peak level before tapering off. Economic slowdowns historically lead to slack demand for commodities and less pressure on companies to raise wages and prices. Also, it has been said that the best solution to high prices is more high prices. The effects of substitution and innovation (technological break-through that we cannot predict) reduce demand for scarce products, services, and resources.

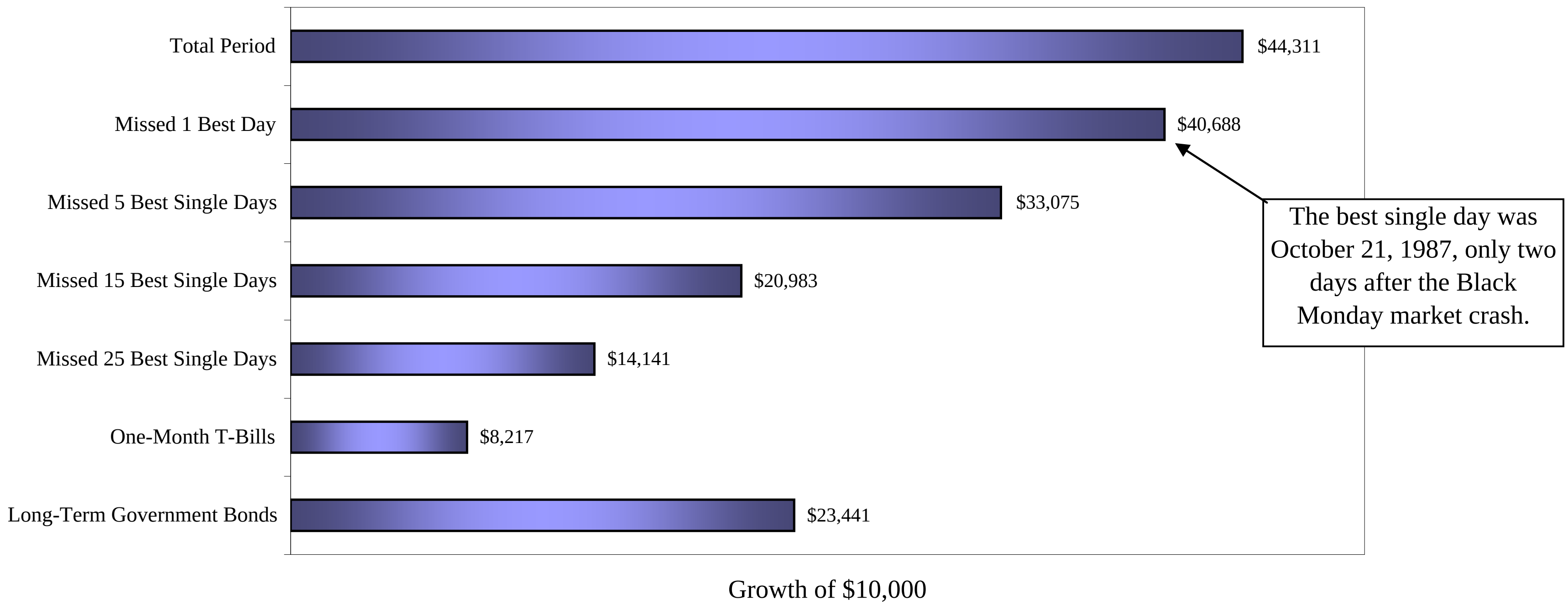
The global economy continues to grow in complexity and adapt to adversity in ways that often defy expectations. Continued openness and free trade assist in this adaptation - as Chinese manufacturing costs increase, manufacturers are simultaneously making productivity gains or shifting production to lower cost venues, such as Vietnam and Indonesia, which may lead to stable unit prices rather than inflation. Likewise, a resolution to the current mortgage mess could be a catalyst for renewed confidence in the financial system and ease pressure on the Federal Reserve to keep interest rates low. Normalized rates and continued global growth could snap us out of a possible stagflationary funk. There are no guarantees. We will continue to strive to understand the possible futures scenarios and invest with discipline and a long view of the markets.

Regards,

Brian J Lawrence, CFA

Performance of the S&P 500 Index

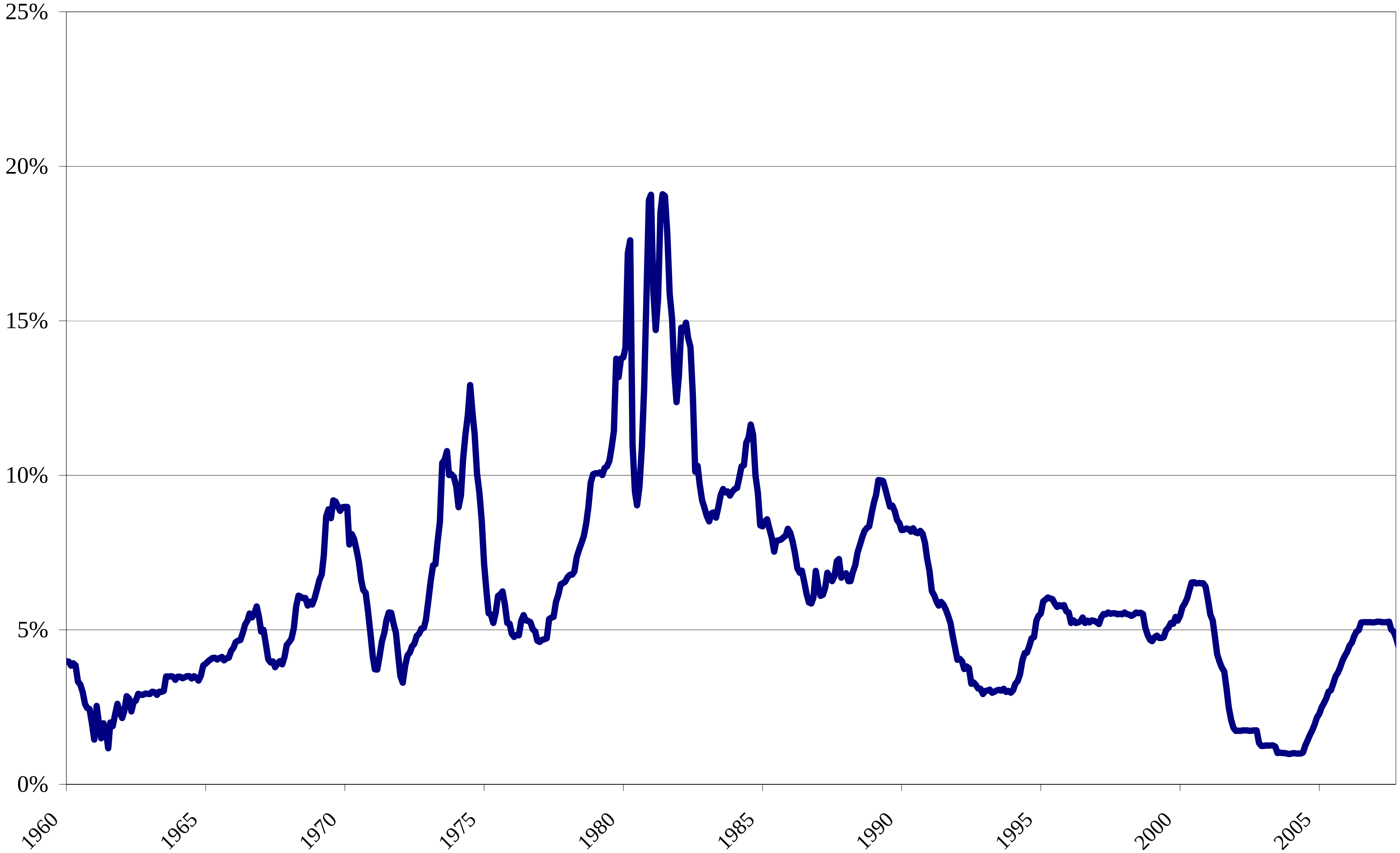
January 1970 - December 2005 (9,122 Total Days)



* The best one-month return, October 1974, happened immediately after the worst one-year period.
* The occurrence of strong positive returns has been especially unpredictable. Investors attempting to wait out an apparent downturn ran a high risk of missing these best periods.

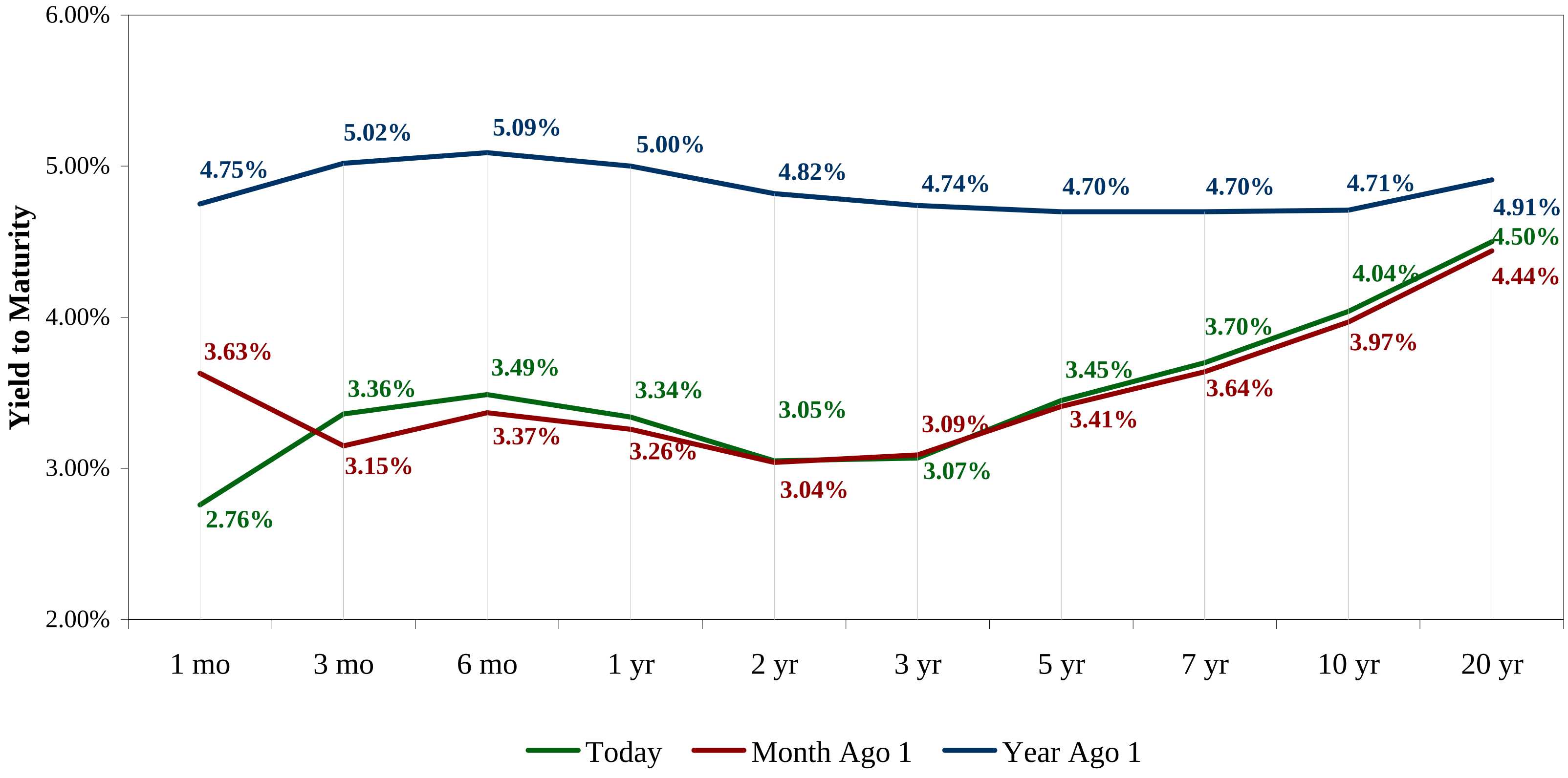
	Total Period	Missed 1 Best Day	Missed 5 Best Single Days	Missed 15 Best Single Days	Missed 25 Best Single Days	One-Month T-Bills	Long-Term Gov't Bonds
Annualized Compound Return	11.1%	10.8%	10.2%	8.8%	7.6%	6.0%	9.2%
% Differential to Total Period	0.0%	-0.3%	-0.9%	-2.3%	-3.5%	-5.1%	-2.0%

FEDERAL FUNDS RATE: JANUARY 1960 - DECEMBER 2007



TREASURY YIELD CURVES

	1 mo	3 mo	6 mo	1 yr	2 yr	3 yr	5 yr	7 yr	10 yr	20 yr
December 31, 2007	2.76%	3.36%	3.49%	3.34%	3.05%	3.07%	3.45%	3.70%	4.04%	4.50%
November 30, 2007	3.63%	3.15%	3.37%	3.26%	3.04%	3.09%	3.41%	3.64%	3.97%	4.44%
December 31, 2006	4.75%	5.02%	5.09%	5.00%	4.82%	4.74%	4.70%	4.70%	4.71%	4.91%



CAPITAL MARKET HISTORY: OVER 10 YEARS OF RETURNS BY ASSET CLASS

These are Annual Returns

Year	Inflation	Money Market	Large Co. Stocks	Small Co. Stocks	International Stocks	Emerging Markets	Total Bond Market	Foreign Bonds	Real Estate	TIPS
12/31/07	3.8	5.2	5.5	-1.6	11.2	36.5	7.0	11.5	-15.7	11.6
2006	2.6	5.1	15.8	18.4	26.3	29.2	4.3	6.9	36.1	0.4
2005	3.4	3.3	4.9	4.6	13.5	30.3	2.4	-9.2	14.0	2.8
2004	3.3	1.4	10.9	18.3	20.3	22.5	4.3	12.1	3.1	8.5
2003	1.9	1.1	28.7	47.3	38.6	51.6	4.1	18.5	36.1	8.4
2002	2.4	1.7	-22.1	-20.5	-15.9	-8.0	10.3	22.0	3.6	16.6
2001	1.6	3.7	-11.9	2.5	-21.4	-4.7	8.4	-3.5	12.4	7.9
2000	3.4	6.3	-9.1	-3.0	-14.2	-31.9	11.6	-2.6	31.0	13.2
1999	2.7	4.9	21.0	21.3	27.0	64.1	-0.8	-5.1	-2.6	2.4
1998	1.6	5.0	28.6	-2.6	19.9	-27.7	8.7	17.8	-17.0	4.0
1997	1.7	5.3	33.4	22.4	1.8	-14.0	9.7	-4.3	19.7	- - -
1996	3.4	5.3	23.0	16.5	6.1	-3.9	3.6	4.1	37.0	- - -
1995	2.5	5.8	37.6	28.5	11.2	-6.9	18.5	19.6	12.2	- - -
1994	2.6	4.5	1.3	-1.8	7.8	-8.7	-2.9	6.0	2.7	- - -
Average	2.6	4.2	12.0	10.7	9.4	9.2	6.4	6.7	12.3	7.6
Risk	0.7	1.7	18.1	17.1	17.4	29.6	5.4	10.5	18.1	5.2

DISCLOSURES & DEFINITIONS

* Statistical data is gathered from Morningstar Principia and/or the fund manager's web site. All information contained in this document is compiled from sources believed to be reliable and current.
* Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of a portfolio.
* As with any investment, the holder of each fund is subject to various risk factors. These factors can be explained on a fund by fund basis.

* The performance data shown represents past performance, which is not a guarantee of future results. Current performance may be lower or higher than the data cited.

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Large-Cap Stocks - A U.S. large company stock index measured by the S&P 500. It is made up of a group of 500 of the most widely traded stocks in the U.S., as chosen by Standard & Poor's.

Small-Cap Stocks- Measured by the Russell 2000 which is the dominant small-cap index in the U.S. The index is comprised of the smallest 2000 stocks in the Russell 3000 Market Index.

International Stocks- An international stock index measured by the MSCI EAFE. It is comprised of stocks from developed markets in Europe, Australia, Asia, and the Far East.

Emerging Markets - An international stock index that tracks non-developed markets throughout the world. It is measured by the MSCI Emerging Markets Index.

U.S. Bonds - A measure of the Total U.S. Bond Market by the Lehman Aggregate Bond Index. It takes into account corporate, government, mortgage and asset backed securities.

Foreign Bonds - Measured by the Citi World Gov't Bond Index. The fund is comprised of primarily investment grade bonds from around the world.

Real Estate - Measured by the Wiltshire REIT Index which is a composite of Real Estate Investment Trusts traded on U.S. exchanges.

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

TIPS - Performance is represented by the Lehman Brothers US Treasury Inflation Protected Securities Index Fund. TIPS are government bonds that have adjustable coupon payments based on the rate of inflation (as measured by the CPI).

Treasury Bills - Short-term government issued securities with maturities less than 90 days. Because they are government issued, T-Bills are free from default risk.