

BROOKMONT CAPITAL MANAGEMENT

“A BUGG’S LIFE”

2100 McKinney Ave., Suite 900, Dallas, TX 75201
RBUGG@BrookmontCapital.com 214-932-6696

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Our Firm Continues to Grow

We are pleased to announce that **Bill Leonard** has joined Brookmont Capital Management and will manage the firm’s activities in Compliance, Operations, Financial Planning, and Client Services. Bill brings more than 20 years of experience in Trust and IRA Administration, Wealth Management, and Investment Services. He joins the firm from Comerica Bank, where he served as Texas Trust Department Manager. A graduate of Austin College, Bill is a Certified IRA Services Professional (CISP) and Certified Trust and Financial Advisor (CTFA).

I have worked side-by-side with Bill for more than eleven years and am excited about the experience and expertise he brings to Brookmont Capital Management.

This also gives me the opportunity to introduce the rest of our team at Brookmont Capital Management. **Neal Scott** is a Principal of the firm and manages our fixed income portfolios. Neal joined the firm from Morgan Keegan and brings nearly twenty years of experience in fixed income securities, institutional bond markets, and bond trading desk activities. Neal graduated from the University of Alabama in 1990.

Suzie Begando joined the firm from Comerica Bank where she recently served as an Investment Associate in the Wealth Management department. At Brookmont Capital, Suzie’s responsibilities include portfolio management, compliance, and the firm’s office management.

Suzie has more than twenty years of experience in asset management, trust operations, and client relations. This past summer, she completed her MBA at the University of Dallas.

I round out the staff at Brookmont Capital and act in the role of Chief Investment Officer and Principal of the firm. My duties include management of our equity portfolios, investment policy, and client communications. Before Neal and I formed Brookmont Capital, I was a Senior Investment Manager at Comerica Bank and ran the Texas Asset Management Department for eleven years.

I believe the success of any business is based on the sum of its parts. I have had the pleasure of working with Bill and



Suzie for more than eleven years, and developed a professional relationship with Neal more than ten years ago. With the addition of Bill Leonard, all of the pieces are in place to offer our clients superior service and professional investment management.

One final piece of housekeeping. Our new website will launch on December 12 and will include additional information on our firm, such as our investment philosophy, staff biographies, fee structure, an archive of past issues of “A Bugg’s Life,” and regulatory information. You will find us on the internet at www.brookmontcapital.com. Content will be added or updated on a continual basis.

Market Update

November was not kind for the equity markets, even though a significant recovery was made during the last few days of the month. Continued problems with sub-prime loans, coupled with rising energy prices and warnings about Holiday retail sales, weighed on most sectors of the market throughout the month. Although November sector returns were discouraging, they have improved significantly since the Thanksgiving holiday. For example, the Financial Sector had dropped more than 16% during the month before recovering half of its decline by the end of November.

Looking forward, the markets will focus on the Federal Reserve’s regular meeting on Tuesday, and updates on holiday sales from major retailers. The market also faces daily reports on the continued meltdown in sub-prime mortgages, so making any short-term predictions about the market’s direction is a crap shoot at best.

Outlook for 2008

As we look into the New Year, the first issue to address is "how can we make predictions about the future when there is so much uncertainty today?" The simple answer is that we do not put too much emphasis on what occurs today or tomorrow, and is why we do not watch CNBC 24 hours a day. The markets can be very volatile on a daily basis and white noise carries most of the blame.

Consider this: the stock markets have seen large one-day movements this year due to the sub-prime mortgage crisis, lower earnings growth, and rising energy prices. Going into 2007, we were well aware that earnings growth was going to decline, and energy prices are always a wild card. The housing market had been on a bubble for at least two years, and when combined with a rational analysis of the mortgage industry, the writing was on the wall for increased foreclosures and problems in the credit markets.

Beyond those three issues, think back to the start of 2007 and see if you can recall any other items that sparked a large one-day drop or rise in the markets. Chances are that most investors cannot name more than two, much less one. So why concern ourselves about one day events that none of us will recall six months from now?

In other words, when we look twelve months into the future, we look at the big picture and decide which three or four major events will drive the markets in 2008. To be more specific, which three or four events will investors remember driving the markets when they look back at 2008?

A. Reversion to the Mean – Consider this: the energy sector has led the S&P 500 for four consecutive years; since

2000, value stocks have easily outperformed growth stocks, and large-caps have underperformed mid and small-cap stocks. Corporate earnings growth has been in double-digits every year since the recession came to an end.

In market terms, trends that last six or seven years are considered an eternity. Eventually, the tide will turn and market sectors that have outperformed year after year will eventually run out of steam. We have seen two perfect examples of this phenomenon during this decade: technology stocks and the real estate market.

There are lessons that we all should learn from these two situations. The first is that any major fad in the investment arena will eventually turn against you, and many times it happens so fast that losses are significant in a short amount of time. The second lesson to learn is that a "reversion to the mean" ALWAYS occurs in the markets. It does not matter if it is the price of gold, sector performance, individual stock prices, domestic stocks versus international, etc. What has led the markets during the past five years should not be where you concentrate your portfolio in 2008.

With that in mind, investors should focus on areas of the market that have underperformed since 2001. This would include large-cap stocks, growth stocks, defensive and growth-oriented sectors, high-quality dividend stocks, and fixed income.

Granted, we have already seen some of this mean reversion in 2007. For example, Growth stocks have

S&P 500 Sector Returns

<u>Sector</u>	<u>November</u>	<u>Qtr-to-Date</u>	<u>Year-to-Date</u>
Energy	-3.99%	-2.99%	23.40%
Materials	-5.10%	-1.30%	18.95%
Industrials	-3.73%	-4.29%	10.80%
Consumer Discretionary	-5.84%	-5.83%	-9.87%
Consumer Staples	2.86%	4.56%	13.01%
Health Care	0.86%	2.73%	8.76%
Financials	-8.05%	-9.88%	-16.04%
Information Technology	-8.09%	-1.54%	13.86%
Telecommunications Services	-7.25%	-8.61%	5.21%
Utilities	0.10%	6.72%	15.77%
S&P 500	-4.18%	-2.66%	6.23%

(as of December 1)

Market Predictions (cont.)

Handily outperformed value stocks, and large-cap names are leading the small-caps. This proves that mean reversion does exist in the markets and fighting against the markets only leads to (opportunity) losses in your portfolio (Mean reversion does not necessarily lead to an actual loss in a specific investment, but better opportunities exist elsewhere in the market).

I am not recommending that you liquidate your value-oriented stocks, or your small-cap holdings. But if your portfolio included a 10% weighting in small-caps back in 2001, and has risen to a 20% weighting due to its strong performance, then take the gains and dial it back to a 10% level (a hypothetical example).

B. Continued Credit Concerns – the fallout in the mortgage sector will not be fixed quickly or easily. The financial industry is not facing the reality that most of the sub-prime loans on their books should be written off, not just written down. We are waiting on the first company to bite the bullet and make the bold announcement that they have taken this step. Instead, we have received a Chinese water torture where companies announce one write-down after another.

I am going to use my Father as an example to state my case. Back in 1972, he purchased a brand new Chevy Vega that had a beige exterior, a tan vinyl interior, and Delco AM radio. He paid \$3,000 for the car and was the first Vega owner in our hometown. Although I was young at the time, I remember how my Dad thought he got a great deal on the car and the neighbors were envious when he brought it home.

It wasn't too long before the car had major issues with the engine, the paint began to rust, and the muffler could be heard two blocks away. When my Dad tried to sell the Vega, he confidently priced it around \$2,500. While the car was not brand new, my Dad's pride led him to believe it was worth that price. To his surprise, he did not get any offers at \$2,500...much less any lookers. Nor did he at \$2,000, or \$1,500, or at \$500. So while Kelly's Blue Book said the Vega was worth \$2,000, no one was willing to buy it at any price.

At that point, was the Vega worth \$2,000 according to Kelly, or was it worth \$0 since he found no buyers at any

price? Now, think of the banks that hold huge amounts of sub-prime debt on their books. Do they write down their holding from the \$3,000 paid at purchase, to the \$2,000 that is stated by auditors? Or do they write-off the investment to \$0 since there is not a buyer for this debt at any price? The answer is whether you want to live in reality, or are too embarrassed to admit that you made a mistake and move on (For the record, my Father learned his lesson from the Vega and never made a similar mistake).

C. November Elections – when President Bush was re-elected in 2004, the markets saw a quick run-up in stock prices, which was followed by a steady decline to pre-election levels. But 2008 could bring a different reaction from the market. Unlike 2004, our country will see a new face in the White House and the Democrats have a legitimate chance of controlling Congress and the Presidency. Four years ago, investors were relieved to see a known entity winning the White House and a continued Republic majority (albeit slim) in Congress. A new President always brings uncertainty as campaign promises rarely get delivered.

The one thing that Wall Street dislikes more than anything is uncertainty. The "unknown" variables lower our confidence in market models and valuation formulas. It brings doubt into economic forecasts. If the unknown variable originates out of Washington D.C., it amplifies investor fear even more.

As we get closer to the November elections, expect to hear few specifics about campaign platforms and increased rhetoric between both parties. There is a lot at stake in the 2008 elections, including control of our government and major issues that need immediate attention. The continued conflict in Iraq, the declining U.S. dollar, the growing Alternative Minimum Tax, soon-to-expire tax breaks, Social Security, and economic growth will prove to be more than Washington can chew.

Market Predictions (cont.)

D. **Muted Economic Growth, Low Inflation** – in our last newsletter, we questioned the Federal Reserve's constant attempts to rescue Wall Street from its own self-induced problems. The Fed has become a "safety-net" for overzealous investment activities and is enabling much of this behavior. Like a parent who tells a child over and over that, "this will be the last time," Wall Street has become accustomed to having the Fed fix the mess and never learns from its own mistakes.

The recession in 2000 was created by a significant decline in corporate earnings. Accounting scandals, corporate fraud, and an overpriced stock market added to the economic decline. In 2008, the possibility of an economic recession would originate from the credit markets and the damage could be more severe. In the last recession, investors took most of the brunt while consumers kept humming along. If a recession were to happen in 2008, consumers and small businesses will hurt the most as the credit markets shut down, housing prices decline, and employment growth slips. The Federal budget is already tapped out, and with tax breaks set to expire in the coming years, the Government does not have the resources to rescue the economy as it did in 2001. Global economies that rely on the U.S. consumer (China comes to mind) would suffer as spending growth falls.

That is the worst case scenario. The more likely outcome is that the Fed will continue to cut interest rates as long as inflation stays under control. Lower interest rates will put added pressure on the U.S. dollar, which could push inflation higher as the price of foreign-made goods rise in response to the lower greenback. While U.S. exports will benefit from a price advantage in foreign markets, U.S. consumers will be hurt as higher domestic prices hit

their pocketbook. As you can see, being a Federal Reserve Governor is not all about luncheon speeches and speaking engagements. It is a thankless job where decisions made today impact global economies well into the future.

Year-Tax Planning

It is not too late to take important actions that will lower your tax bill for 2007. Increased market volatility normally translates into sizable gains AND losses in equity portfolios and you may need to realize a large gain or loss to offset what has been taken during the year.

If you own equity mutual funds outside of a tax-deferred account, contact the fund company to find out what gains may be distributed by year-end. They may not know an exact amount, but can provide a rough estimate.

While the Senate passed legislation on Thursday that will keep 50 million American taxpayers from falling into the Alternative Minimum Tax trap, you could find yourself paying higher taxes under the AMT if you have triggered certain items. Exercising incentive stock options, residing in a state with high income taxes, realizing a large amount of long-term capital gains, claiming numerous dependents, or claiming a significant number of itemized deductions are the most common AMT triggers.

For more information on the Alternative Minimum Tax and other year-end tax planning strategies, we recommend that you speak with your CPA. Brookmont Capital provides tax-sensitive portfolio management that can also help reduce your annual tax bill.

Lipper Index Performance

	<u>YTD</u>	<u>1 Year</u>	<u>3-Yr</u>
Large-Cap Growth	14.87%	14.27%	10.14%
<i>Large-Cap Value</i>	<i>3.67%</i>	<i>5.47%</i>	<i>12.23%</i>
Mid-Cap Growth	20.17%	15.30%	14.90%
<i>Mid-Cap Value</i>	<i>3.88%</i>	<i>3.30%</i>	<i>15.88%</i>
Small-Cap Growth	9.72%	8.73%	13.89%
<i>Small-Cap Value</i>	<i>-3.76%</i>	<i>-3.87%</i>	<i>14.36%</i>
International Equity Median	16.08%	17.94%	21.09%
<i>Intermediate Corp. Bond</i>	<i>5.30%</i>	<i>4.13%</i>	<i>4.27%</i>

(As of 11/30/2007)

Rates Head South

Like birds migrating South for the winter, interest rates on fixed income securities are going lower as the days get colder. The combination of interest rate cuts by the Fed and slower economic growth has translated into declining yields across all areas of the bond market. The most dramatic change in yield has occurred with the 10-year Treasury, which has fallen 25% from its one-year high. With the Fed expected to reduce short-term rates at its December 11 meeting, investors should expect further declines in yields. Portfolios that are holding a large percentage in money market funds will be pinched as additional interest rate cuts by the Fed will eventually result in lower yields for cash holdings. We do not expect a return to 2003 when money market rates fell below 1%, but we could easily see a 3% yield in early 2008.

If you find yourself in a similar situation, consider buying a short-term bond ladder that consists of very high-grade corporate bonds or investment-grade municipals if you need tax-free income. We see little value in Treasury debt as their yields have declined significantly.

As I mentioned at the beginning of the newsletter, Neal Scott is our fixed income expert and he would be happy to answer any questions you may have on your existing bond portfolio or any other issues regarding the bond market.

	<u>52-week High</u>	<u>Current</u>
90-day T Bill	5.04%	3.02%
6 Month T Bill	5.18%	3.15%
Ten Yr Treasury	5.20%	3.82%
Lehman Gov't/Corp	5.73%	4.40%

DISCLOSURE

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Robert Bugg – Principal and Chief Investment Officer

214-932-6696

Neal Scott – Principal and Fixed Income Manager

214-932-6647

Bill Leonard – Director of Client Services

Suzie Begando – Portfolio Manager and Compliance

214-932-6712

Brookmont Capital Management

2100 McKinney Ave
Suite 900
Dallas, TX 75201

Phone:
214-932-6696

E-Mail:
Rbugg@BrookmontCapital.com

