

June 30, 2008

“Unable to raise rates for fear of sinking the debt-laden U.S. consumer, and unable to lower rates for fear of appearing weak on inflation and likely undermining the already weakened U.S. dollar, the Fed is in a box— unable to do anything except make speeches”

Fred Hickey

The High Tech Strategist
July 2, 2008

	Q2 (%)	YTD (%)
Regan Absolute Return Portfolio	-0.90	-0.95
Regan Aggressive Portfolio	-3.72	-5.18
Regan Futures Portfolio	-2.5	.60
HFRX Absolute Return Index	-0.05	-1.2
S&P 500	-2.7	-11.9
NASDAQ	.61	-13.6
US 10 Year Bond	-4.2	.37
Gold	.44	10.5
Commodity (DJ AIG)	16.7	26.0
US Dollar	.96	-5.5
Oil	39.0	46.2

Value of \$100,000 invested on January 1, 2000

Regan Absolute Return Portfolio **\$187,000**

S&P 500 **\$98,000**

NASDAQ Composite **\$58,000**

Market Review

The second quarter provided more volatility as the daily financial news moved from positive to negative throughout the quarter. After a strong bounce from the March low, the S&P 500 regained almost all of its losses for the year in early May. Recent negativity however, has caused the index to break the March low and while there appear to be some good values, the old saying “Never catch a falling knife” seems to apply now more than ever.

As shown in Bert Dohmen’s chart of the NASDAQ to the right, the advance in early March was a little suspect do to the lack of follow through in the advance/decline line. In a healthy market, stock advances will outnumber declines and the A/D line will rise with the index. While the “generals” (Apple, Research In Motion, Google) had nice advances, the majority of stocks did not.



The yield curve steepened as interest rates in longer dated bonds have begun to rise. The 90 day t-bill yields a measly 1.77% but the 30 year treasury bond offers 4.5%. Real inflation has continued to rise and is putting the Fed in a very difficult position. While we feel that the Fed is on hold until at least February of 2009, the question is, will they raise rates to combat inflation, or will they lower rates to help the consumer which is 70% of our economy?

Commodities did very well again this quarter (+26%) with oil leading the way. While there are compelling arguments both in favor and against the rise in commodity prices, the supply/demand theory seems to be winning for the moment. We continue to believe that commodities are subject to downside pressure in the short-term.

In fact, we compare the oil story to that of Chinese equities. Both are built on the idea of a strong global economy. The arguments regarding increasing demand for oil and the growing middle class in China have most people seeing only upside for both investments. As shown in the chart to the right, the global story did not protect Chinese stocks from losing 40% in the first 6 months of 2008 and the jury is still out on oil. The charts look eerily similar.



Performance

Our portfolios did relatively well against the major indices.

As mentioned last quarter, “We maintained most of our capital and will be around to fight another day.” Asset class selection continues to be the key to performance in a market where nearly all asset classes are down. Considering one would have had to be invested mainly in commodities or short the stock market to make any return, we feel very fortunate to be sitting with a 1% loss year to date. As always we will continually be on the watch for major trend changes, inefficient market pricing, and shifts in fundamental valuations so that we can adjust your portfolios to take advantage of whatever the market presents us.

As shown in the chart to the right, we are still very defensively invested with about 28% net exposure to high-grade stocks (Stocks minus 2X Equity Hedge) which have low to fair valuations and a few high growth issues (Biogen, Celgene, Apple, etc). While we won't hesitate to be buyers of value, now is not the time to be a hero. Financial stocks interest us and we may buy high quality names if they fall too far. Our goal would be to ease our way in, and increase our positions on continued strength.

Most of the quarter was spent hedging the portfolio for downside risk. We did buy a small position in Intel, as we feel that the company will benefit from the boom in mobile computing. Intel has a near monopoly on the mobile processor market and with Apple now using Intel processors, lost PC business will be replaced with gains in Apple market share.

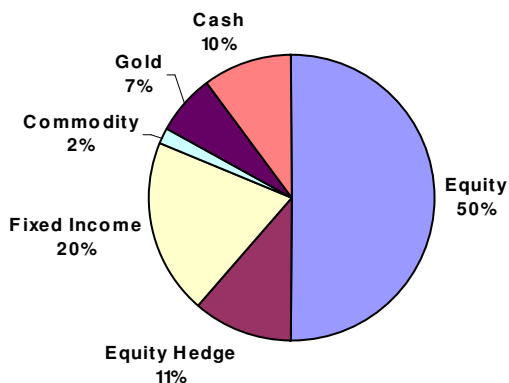
On the sell side, we sold our position in Pfizer and some of the Healthcare ETF. This has been a classic case of chasing yield, and while it was hard to sell Pfizer at \$20, it appears for the time being it was the right trade, with shares now trading around \$17. We still like the healthcare sector, but will wait until we see signs of strength before adding to our positions.

One of the more interesting names on our buy list is the Washington Mutual (WAMU) bond that matures in January 2009. We feel that the risk of bankruptcy is low considering what happened with Bear Stearns. JP Morgan has shown interest in WAMU in the past, and a takeover would increase the rating on these bonds to A or higher. While there is subprime risk, the traditional banking business is a very nice asset. There are only five months left until maturity, and in the event we do not sell, our positions will return about 9%.

The Regan Portfolio is a proxy for our average account. Performance numbers may not accurately reflect each individual account. The portfolio is constructed using a weighted average of a group of accounts that are fully managed by Regan Investments Inc, and that are of a size congruent to our balanced account parameters. Past performance does not guarantee future results. Investing in the stock market involves investment risk including possible loss of principal. There is no guarantee that the views expressed in this communication will become a reality.

Our Portfolio

Regan Asset Class Breakdown



Inflation

Inflation, as most think of it, is the rise in price of goods and services. There are many other variables in inflation like money and credit creation, but these go beyond the scope of this newsletter.

Inflation continues to run rampant throughout the world (China +8%, India +12%, Ukraine + 30%, and Iran +20%). According to the Bureau of Labor and Statistics (BLS), the 12 month change in the Consumer Price Index, or CPI in the US (less energy and food) is only 2.3% (See chart below). While we all know that “real” inflation is much higher, mainly due to the energy and food components that are conveniently excluded, it makes sense to look at how inflation affects investors. In fact, we feel that the inflation dilemma is key to investment survival over the next 10-15 years.

Table A. Percent changes in CPI for All Urban Consumers (CPI-U)

Expenditure Category	Seasonally adjusted							Compound annual rate 3-mos. ended May 2008	Un-adjusted 12-mos. ended May 2008
	Changes from preceding month								
	Nov. 2007	Dec. 2007	Jan. 2008	Feb. 2008	Mar. 2008	Apr. 2008	May 2008		
All items	0.9	0.4	0.4	0.0	0.3	0.2	0.6	4.9	4.2
Food and beverages .....	.4	.1	.7	.4	.2	.9	.3	5.9	5.0
Housing .....	.4	.3	.2	.2	.4	.3	.5	4.9	3.3
Apparel .....	.6	.1	.4	-.3	-1.3	.5	-.3	-4.3	-.6
Transportation	3.5	1.0	.5	-.7	.7	-.7	2.0	8.7	8.1
Medical care .....	.4	.3	.5	.1	.1	.2	.2	1.8	4.1
Recreation .....	.2	.0	.2	.1	.3	-.1	.1	1.0	1.2
Education and communication .....	.0	.3	.4	.1	.3	.4	.4	4.2	3.0
Other goods and services .....	.2	.3	.4	.2	.4	.5	.4	5.3	3.6
Special indexes:									
Energy	6.9	1.7	.7	-.5	1.9	.0	4.4	28.2	17.4
Food .....	.4	.1	.7	.4	.2	.9	.3	6.2	5.1
All items less food and energy .....	.2	.2	.3	.0	.2	.1	.2	1.8	2.3

Social security payments and cost of living wage increases are all tied to the CPI number. In addition, so are Treasury Inflation Protected Securities (TIPS) which many investors use as a hedge against loss of purchasing power. So, while our everyday prices are rising at an estimated 8-12% range, our income adjustments are only rising at a rate of 2.3%.

As we have advocated, there are other means of protecting against inflation. Stocks and commodities are generally seen as a hedge against inflation, but gold is typically viewed as the best protection against the loss of purchasing power. While some would argue that the metal does not have utility, it has been a consistent store of value for hundreds of years. Much longer than any paper currency.

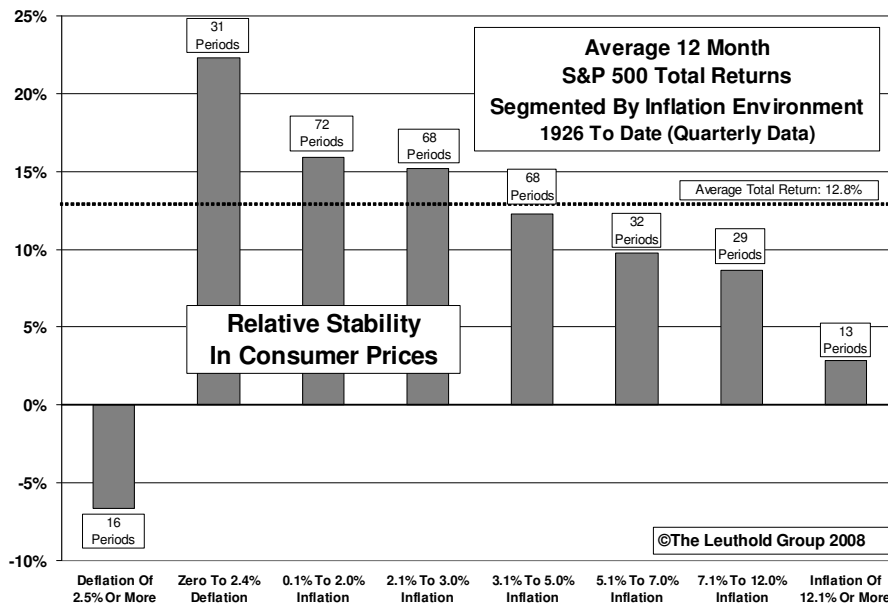
What are the consequences of inflation to our asset class methodology? First, a rise in inflation will ultimately force the Fed to raise interest rates thus causing bond prices to fall. This is one reason we do not like the fate of longer dated bonds. We are much more comfortable in the 3-5 year maturities, where inflationary risk is much less.

Inflation, cont'd.

Most fixed income investors forget the inflation component when they choose their investments. A guaranteed 4% annuity/bond/CD sounds great in a world of -15% equity returns, but that fixed rate is usually measured before inflation, and in the event it is indexed to inflation, it is more than likely adjusted by the bogus CPI number (2.3%). The problem with these investments is that a year from now, interest rates may be at 5% and equity returns may be +10% and “real” inflation might be at 8%. That leaves the fixed income investor not only losing in real terms (4 - 8 = - 4%) but it also leaves the investor no opportunity to achieve superior performance in better performing asset classes.

Commodities typically do quite well in inflationary times because they are “stuff”. Typically it is the rise in raw materials that ultimately leads to a rise in consumer prices, and that is why you see the price of everything that involves transportation rise with the price of gasoline.

Stocks are generally viewed as a hedge against inflation, but according to the table below, (originally taken from Steven C. Leuthold’s book “The Myths of Inflation and Investing” and reprinted with kind permission by The Leuthold Group) that is not always the case. In fact, Leuthold suggests that stocks perform best in periods ranging from moderate deflation to moderate inflation. Periods of high inflation show stocks performing much poorer than the historical average and periods of significant deflation are historically very negative for stocks.



As the economy wages a battle between inflationary and deflationary forces, asset allocation is key to investment performance. More importantly, traditional asset classes (stocks, bonds, cash) need to be upgraded to include commodities and currency components in order to ensure complete diversification. Nobody can predict the future, but it is hard to win at chess playing with only rooks and pawns.

Airlines

One of the most asked questions this quarter has been “Why are we hanging on to our Northwest Airlines (NWA) position?” While no one likes to sit on a big loss, the question now remains one of opportunity. In other words, is there more opportunity in cash, other stocks, or bonds?

We feel that the airlines represent one of the largest opportunities in the stock market today. The entire Amex airline index less Southwest Airlines is worth roughly \$17B. This means that nearly the whole industry is worth as much as Western Union. There is no other sector, apart from possibly the mortgage industry, that is looked upon less favorably than the airlines. Valuations are extremely cheap as most of these companies are trading around 50% of book value. Most commercial passenger planes are sold out, driving is not exactly a viable substitute, and consolidation is inevitable.

The airlines have trouble with regards to legacy costs and higher fuel costs. But make no mistake, air travel is not going anywhere soon. These companies are selling at very distressed levels, and will rebound fast with a decline in the price of oil. They have now increased revenues by charging for basically everything that is brought aboard, and those price increases will continue even in the face of lower fuel costs. In essence, their margins should increase considerably if oil subsides.

While we may look to sell our NWA position to capture tax losses, we would look to buy one of the other large carriers (United, American, Delta, etc). Our thought is that the price of oil could easily fall to \$100 per barrel. This would represent roughly a 30% decline. In 2003, oil declined roughly 21% and the airline index increased 100%. In 2006, oil declined 31% and the airlines increased roughly 40%.

While it is always difficult to be buyers when there appears to be no hope, the chart below shows just how severe the airline index has declined. At the bottom of the market crash in 2002, the NASDAQ had fallen nearly 75% and no one wanted to buy tech stocks. Looking back, that was a very good time to be buying, as the NASDAQ gained nearly 70% in the next 6 years.



Thank you for your continued faith in us, and we hope you have a wonderful Summer!