



Overview

Fourth Quarter 2007

We Had a Good Year in 2007...

Capital Advisors' managed accounts performed well in 2007. A preliminary calculation for a composite of fully discretionary equity portfolios indicates a return of approximately 11.4% for the year as a whole, net of fees and expenses. By comparison, the *S&P 500 Index* produced a total return of 5.58% in 2007.

Most managed bond accounts produced returns between four and eight percent in 2007, with the variance being driven by client-specific differences in investment objective (for example, the relative emphasis on current income vs. preservation of capital), and tax structure (taxable vs. tax-free municipal bonds). For context, the *Lehman Aggregate Bond Index* was up 6.97% in 2007. Statements will go out shortly for all clients that include performance data for 2007.

...But Enough about Last Year

As happy as we are to report good news about last year's performance, we are even more excited for the year ahead because we expect to participate in a "once-in-a-decade" caliber investment opportunity sometime in the New Year. If we're right, the opportunity will be found in the beaten down stocks of companies in the financial sector.

We are relying on lessons from four previous industry melt-downs to calibrate our expectations for the current crisis in the financial sector. The previous episodes we have used as a benchmark include the technology bust in 2001-02; the implosion of "merchant" energy companies in 2001-02; the crash in healthcare stocks in 1992-93 associated with then First Lady, Hillary Clinton's ill-fated healthcare reform proposals; and the savings & loan/banking crisis in 1990-91.

If these four episodes represent a relevant proxy for the crises now unfolding in financial sector, an opportunity should present itself soon to make a lot of money! With a little luck in 2008 the next few years might be an exciting *and rewarding* time for Capital Advisors' managed stock portfolios.

The Aftermath of 100-Year Floods...

The most commonly cited analogy for large-scale financial market implosions is that of a 100-year flood. The appeal of this analogy in times of stress is its implication that something *way* outside the norm has just occurred.

The recent unraveling of the credit markets is such an event. The confluence of variables that came together to trigger the crisis delivered such a surprise to the consensus opinion about home prices, and other collateral values important to the credit markets, that a massive adjustment was needed to re-calibrate expectations with reality. This adjustment process expressed itself in the form of collapsing prices, as is typically the case when reality dramatically under-shoots an overly optimistic belief structure about a given industry sector.

In formulating an outlook for financial stocks in 2008, the more relevant aspect of 100-year flood events is their aftermath. Since the asset price declines associated with such events are extraordinary, it makes sense that the price *recoveries* that follow these episodes might be extraordinary as well. To test the validity of this hypothesis we conducted a study of the four most recent market sector spasms of comparable magnitude to the present situation.

As mentioned above, the four periods we studied include the busts in technology stocks and merchant energy companies earlier this decade, the panic in healthcare stocks associated with “HillaryCare” in 1992-93, and the collapse of many financial stocks in the early 1990s associated with a banking and savings & loan crisis. The methodology for the study was as follows:

- 1) We located the date and price for the “low-water mark” stock price of representative companies in each of these four sectors.
- 2) We added 25% to each low-water-mark stock price to adjust for the reality that it is impossible to commit real money to any stock at its 52-week low without the benefit of hindsight, or blind luck. There is no magic to this 25% threshold. It was chosen as a realistic margin for error within which an investor operating in real-time might initiate a new position in a beaten-up stock.
- 3) We measured these companies’ stock prices on December 31 of each of the five subsequent years following the bear market low.
- 4) We calculated the total return, including dividends, from an assumed starting point 25% above the low-water-mark stock price to each subsequent year-end stock price.

Historical Studies

The results of these studies are presented in the tables below.

Financial Sector Study 1990 - 1995

| Company | Adjusted Low Price* | Date | Return To: Dec. 1991 | To: Dec. 1993 | To: Dec. 1995 |
|------------------|---------------------|----------------|-------------------------|------------------|------------------|
| AIG | \$7.73 | 10/11/90 | 35.2% | 82.7% | 191.4% |
| American Express | \$5.59 | 10/17/90 | -1.4% | 58.8% | 157.8% |
| Bank of America | \$5.31 | 10/30/90 | 102.2% | 160.3% | 297.6% |
| Bank of NY | \$2.30 | 10/30/90 | 90.7% | 276.7% | 594.1% |
| Citigroup | \$1.74 | 10/9/90 | 78.6% | 263.9% | 509.7% |
| Fannie Mae | \$8.36 | 10/11/90 | 112.3% | 152.5% | 323.4% |
| Freddie Mac | \$3.38 | 10/30/90 | 250.4% | 295.2% | 586.2% |
| JP Morgan | \$4.23 | 10/31/90 | 79.8% | 263.0% | 473.0% |
| Merrill Lynch | \$2.53 | 10/16/90 | 206.1% | 352.1% | 473.7% |
| T. Rowe Price | \$1.11 | 10/17/90 | 157.7% | 244.5% | 505.3% |
| Wachovia | \$8.60 | 1/15/91 | 83.2% | 169.7% | 293.8% |
| Wells Fargo | \$2.21 | 10/13/90 | 116.0% | 204.3% | 339.0% |
| | | Average | 109.2% | 210.3% | 395.4% |

* The "Adjusted Low Price" is calculated by adding 25% to the lowest closing price achieved by each stock during the study period. Prices are also adjusted for all stock splits. Returns include reinvested dividends.

Healthcare Sector Study 1993 - 1998

| Company | Adjusted Low Price* | Date | Return To: Dec. 1994 | To: Dec. 1996 | To: Dec. 1998 |
|-------------------|---------------------|----------------|-------------------------|------------------|------------------|
| Abbott Labs | \$13.45 | 8/11/93 | 17.1% | 98.4% | 279.9% |
| Amgen | \$4.93 | 8/12/93 | 49.8% | 176.2% | 431.1% |
| Bristol-Myers | \$15.20 | 8/12/93 | -2.1% | 98.4% | 402.0% |
| Eli Lilly | \$13.64 | 8/13/93 | 27.3% | 199.4% | 647.9% |
| Express Scripts | \$0.80 | 4/8/93 | 186.8% | 180.0% | 947.8% |
| Genzyme | \$7.65 | 12/20/93 | -2.0% | 35.4% | 219.7% |
| Johnson & Johnson | \$11.14 | 8/11/93 | 26.7% | 138.2% | 312.7% |
| Medtronic | \$4.16 | 4/8/93 | 69.8% | 319.3% | 825.0% |
| Merck | \$17.01 | 8/13/93 | 11.7% | 144.5% | 368.5% |
| Pfizer | \$5.63 | 2/22/93 | 19.5% | 166.8% | 720.0% |
| Schering Plough | \$8.29 | 2/22/93 | 16.7% | 114.4% | 651.0% |
| St. Jude Medical | \$5.31 | 10/22/93 | 26.5% | 102.2% | 33.0% |
| United Health | \$3.29 | 2/22/93 | 72.0% | 71.7% | 64.5% |
| Wyeth | \$17.54 | 2/22/93 | -3.8% | 97.7% | 265.2% |
| | | Average | 36.9% | 138.8% | 440.6% |

* The "Adjusted Low Price" is calculated by adding 25% to the lowest closing price achieved by each stock during the study period. Prices are also adjusted for all stock splits. Returns include reinvested dividends.

**Technology Sector Study
2002 - 2007**

| Company | Adjusted Low Price* | Date | Return To: Dec. 2003 | To: Dec. 2005 | To: Dec. 2007 |
|-------------------|----------------------------|----------------|---------------------------------|--------------------------|--------------------------|
| Amazon.com | \$15.61 | 7/25/02 | 237.0% | 202.0% | 505.0% |
| Apple | \$8.50 | 10/9/02 | 25.8% | 746.3% | 2,252.3% |
| Applied Materials | \$12.94 | 10/8/02 | 73.4% | 39.4% | 41.9% |
| Cisco | \$10.75 | 10/8/02 | 125.4% | 59.3% | 156.4% |
| Dell | \$27.91 | 5/7/02 | 21.7% | 7.3% | -9.9% |
| Ebay | \$15.54 | 4/26/02 | 108.0% | 178.3% | 119.5% |
| EMC Corp. | \$4.79 | 10/4/02 | 169.7% | 184.3% | 285.0% |
| Hewlett-Packard | \$13.95 | 10/9/02 | 68.1% | 115.5% | 292.9% |
| IBM | \$68.84 | 10/9/02 | 35.9% | 22.6% | 68.8% |
| Intel | \$16.53 | 10/8/02 | 94.8% | 54.7% | 72.6% |
| Microsoft | \$26.78 | 7/25/02 | 3.1% | 11.3% | 58.0% |
| Motorola | \$9.64 | 2/7/03 | 64.9% | 202.5% | 122.5% |
| Nokia | \$13.45 | 8/5/02 | 29.1% | 45.4% | 221.8% |
| Oracle | \$9.15 | 6/3/02 | 44.6% | 33.4% | 151.0% |
| Qualcomm | \$14.85 | 8/5/02 | 82.8% | 196.4% | 178.9% |
| Sun Microsystems | \$12.04 | 10/4/02 | 47.5% | 38.3% | 50.2% |
| Texas Instruments | \$16.54 | 10/9/02 | 78.6% | 96.5% | 107.9% |
| Yahoo | \$5.63 | 9/24/02 | 300.3% | 596.5% | 316.9% |
| | | Average | 89.5% | 157.2% | 277.3% |
| | | X-Apple | 93.2% | 122.6% | 161.1% |

** The "Adjusted Low Price" is calculated by adding 25% to the lowest closing price achieved by each stock during the study period. Prices are also adjusted for all stock splits. Returns include reinvested dividends.*

**Merchant Energy Sector Study
2002 - 2007**

| Company | Adjusted Low Price* | Date | Return To: Dec. 2003 | To: Dec. 2005 | To: Dec. 2007 |
|----------------|----------------------------|----------------|---------------------------------|--------------------------|--------------------------|
| Duke Energy | \$8.96 | 3/10/03 | 39.3% | 105.1% | 184.5% |
| Dynegy | \$0.64 | 7/25/02 | 568.8% | 656.3% | 1,037.5% |
| El Paso Corp. | \$4.31 | 2/13/03 | 94.5% | 198.7% | 335.4% |
| PG&E | \$10.24 | 10/16/02 | 171.2% | 274.8% | 366.6% |
| Reliant Energy | \$1.25 | 10/18/02 | 466.2% | 693.8% | 1,913.1% |
| TXU Corp. | \$6.80 | 10/16/02 | 80.2% | 700.2% | 1,058.6% |
| Williams Cos. | \$1.10 | 7/25/02 | 804.8% | 2,073.9% | 3,400.8% |
| Xcel Energy | \$7.08 | 7/29/02 | 161.0% | 211.0% | 316.6% |
| | | Average | 298.3% | 614.2% | 1,076.6% |

** The "Adjusted Low Price" is calculated by adding 25% to the lowest closing price achieved by each stock during the study period. Prices are also adjusted for all stock splits. Returns include reinvested dividends.*

Lessons from the Data...

We would highlight the following key points from the data in these historical studies:

- 1) The recovery process from past “major” market sector adjustments has provided remarkable long-term investment opportunities in the stocks of companies in the affected industries.
- 2) It isn’t necessary to catch the 52-week low in a stock to participate handsomely in its longer-term recovery. Returns can be *great* if your entry point is within 25% of the low, and in many cases, returns have been “good enough” from starting points 50% or more above the bear market low for stocks in sufficiently beaten-down sectors.
- 3) It isn’t necessary to play the “fringes” of a busted industry sector – rewards from owning the leading companies with the strongest balance sheets have been plenty good in the past (although for those who like risk – take a look at the data for merchant energy companies after 2003!!).
- 4) The recovery process from past industry wash-outs is surprisingly broad – of the four episodes presented above, only *one* stock – **Dell** – produced a loss after five years.
- 5) Stocks within the same industry sector can bottom out in bunches. The studies above suggest that an important clue that marks the bottom of a sector down-trend can be a common date (i.e. within the same 5-10 days) for a recent low-water-mark shared by several stocks in the sector.

Blueprint for a Fifth Study – The Financial Sector Today...

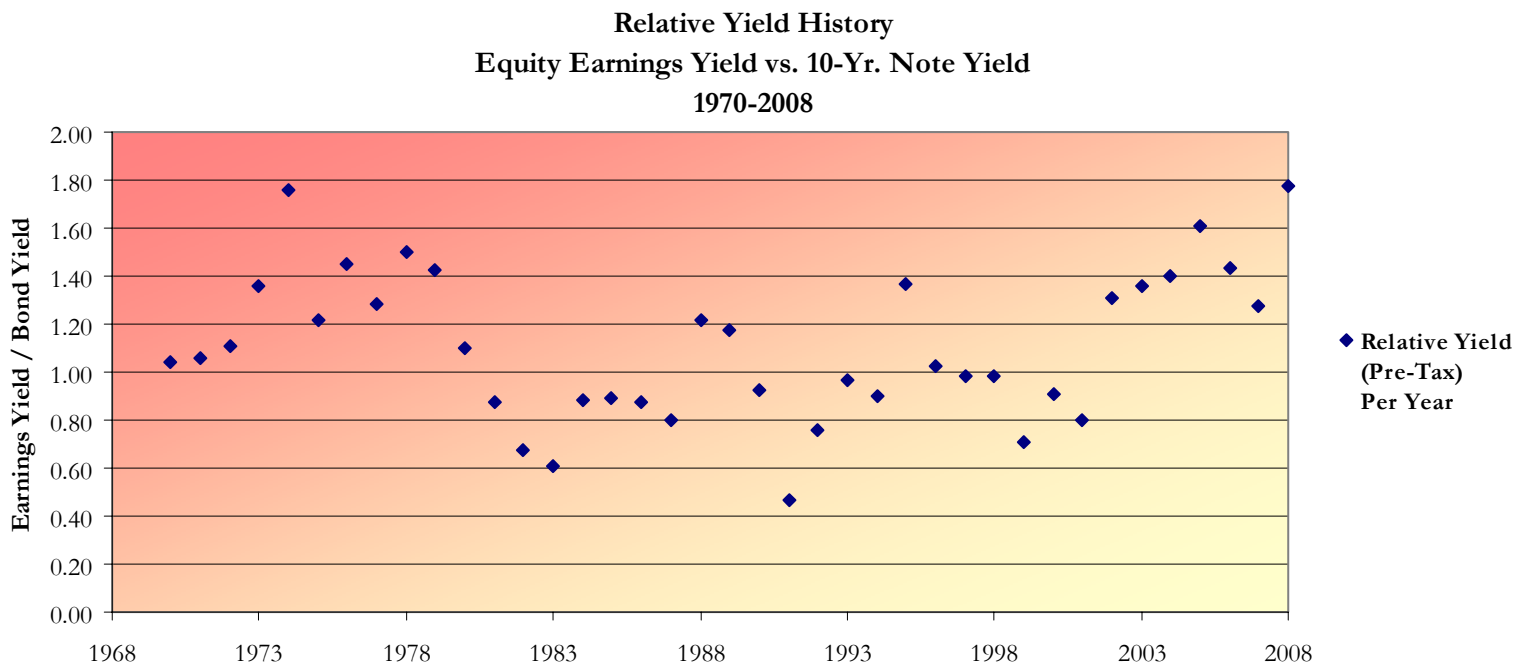
While we realize it is impossible to call the bottom in any stock in advance, we believe we might be getting close in the case of financial stocks today. Valuation metrics for many financial stocks are at low levels not seen since the last crisis in the financial sector in 1990-91 (see the study above for the aftermath of that period). Factors that seem capable of limiting further downside in the financial sector from here include:

- 1) The pace of asset write-downs from sub-prime debt and structured investments holdings seems likely to slow in coming months as many firms have already booked substantial write-offs.
- 2) Monetary policy actions from Central Banks worldwide, particularly the U.S. Federal Reserve, have been structured to alleviate marketplace concerns about the credit markets’ ability to function properly.
- 3) If recently sluggish economic data persists into 2008 the Fed seems likely to cut interest rates further, likely leading to a “steep” yield curve environment (this refers to a condition in the credit markets where the spread between yields on short-maturity debt versus longer-maturity debt are wide). The earning power of many financial institutions improves markedly in a steep yield curve environment.
- 4) History is on the side of a recovery for the sector, at least according to Thomas Lee, **JP Morgan’s** Chief Strategist, who recently made the point that the financial sector quickly purges itself of bad business and excess capacity, which explains why stocks in the financial sector has suffered consecutive bad years only once in four decades, and why a down year in the finance sector is frequently followed by double digit gains the next year, according to Lee’s research. (*Source: Barron’s, Dec. 24, 2007*)

The Stock Market *Can* Be Rewarding Despite a Weaker Economy...

Most economists expect a lackluster start to the New Year for the domestic economy. Many are even forecasting a recession for the U.S. economy in 2008. In light of the risks a slowing economy can present for the stock market in the coming year it seems worth acknowledging that stocks performed reasonably well in 2007 in the face of equally daunting risk factors like surging oil prices, an unprecedented collapse in housing prices, and a severe credit crunch.

We believe U.S. stocks can finish 2008 with a gain as well, in spite of the known risks, in large part because current valuation measures suggest a lot of bad news is already priced into stocks. We have presented the chart below in past commentaries to illustrate the long-term relationship between the “yields” of stocks and bonds. The updated version below shows that stocks have not been as cheap as they are today, relative to bonds, since 1974!



Comment: “Fair Value” in the stock market at any given time is dependent upon the relative attractiveness of alternative investment options available in the marketplace. The scatter gram above plots the relative earnings yield in the stock market (i.e. earnings divided by price, or the inverse of the P/E ratio) versus the 10-year government bond yield. As of January 2008 the earnings yield in the stock market is close to 77% higher than the 10-year bond yield – a level not seen since September of 1974. Lehman Brothers notes that equities outperformed debt by 24 percentage points in the following 12-months from October 1974 to October 1975.

Source: *Bloomberg, LP (Bonds); Value Line (Equity); 2007 P/E estimated by Value Line. 2008 P/E calculated by using Standard & Poor’s 2008 Operating Earnings estimates as of 12/31/07 and the S&P 500 Index Closing Price as of 01/04/08.*

Strategy for Bonds

Our strategy for the fixed income market has not changed materially since our last commentary in October. The prospect of continued monetary easing from the Fed in coming months suggests the following about our near-term strategy in the bond market:

1. We will continue to emphasize non-callable bonds in client portfolios (callable bonds can be counter-productive in a falling interest rate environment).
2. Yield “spreads” have widened in recent months for all levels of corporate and agency bonds, including those of very high credit quality (i.e. the yield premium available in corporate and agency bonds relative to U.S. Treasuries is more attractive today). We will emphasize high-grade corporate and agency bonds relative to Treasuries so long as these attractive yield spreads persist.
3. Tax-exempt municipal bonds seem particularly attractive today for investors in the higher tax brackets. Recent disruptions in the credit insurance industry have created a unique situation in the municipal bond market in that many high quality muni bonds offer pre-tax yields equal to those of taxable government bonds. When these pre-tax yields are adjusted for taxes the spreads available in muni bonds today are as favorable as they have ever been! Throw in the very real possibility of a higher income tax regime in 2009 and beyond and the appeal of tax-free municipal bonds seems even greater today.

Summary

We expect the stock market to be volatile again this year with potential for further downside from current levels in the near term, likely driven by more frequent earnings “misses” among companies whose business might suffer in a slowing economy.

Last year, large-cap stocks outperformed small-caps, and growth stocks outperformed value stocks, for the first time in six years. We expect this trend can continue in 2008 because leading companies in growing industries (i.e. “large-cap growth stocks”) frequently perform relatively better during the latter stages of an economic expansion when dependable earnings growth commands a greater premium in the marketplace.

The relative valuation of stocks versus bonds recently reached an extreme that suggests plenty of bad news is already priced into the domestic stock market. To the extent that any of the numerous risks currently facing the global economy resolve themselves favorably throughout the year, there is room for “relief rallies” to carry stocks higher by this same time next year.

We are most excited about opportunities we expect to develop in the financial sector in 2008. If the recovery process from the recent collapse in financial stocks follows a similar pattern to comparable sector-specific melt-downs from the past, we may be witnessing a once-in-a-decade caliber investment opportunity. We intend to take advantage of it!

There also appears to be a unique opportunity in the bond market today for investors in higher tax brackets. Yield spreads between taxable government bonds and tax-free municipal bonds have collapsed to near parity, which implies an unprecedented yield advantage for tax-exempt muni bonds on an after-tax basis. If you don't know whether municipal bonds make sense for you, please call us to discuss it.

Finally, look for statements for your portfolios to arrive shortly with performance data for 2007. We hope you will be pleased with the results. As always, never hesitate to call with your questions and comments.

Happy New Year.

January 7, 2008

DISCLOSURES

Introduction

The investment return and principal value of an investment will fluctuate so that an investor's portfolio may be worth more or less than its original cost at any given time. Current performance of the separate account composites may be lower or higher than the performance quoted. Due to differences in portfolio timing and position weightings, the returns for any individual portfolio managed by Capital Advisors may be lower or higher than the performance quoted.

Composite Performance Calculation

Equity Composite: The Capital Advisors Equity Composite includes all discretionary accounts with market values greater than \$200,000 executing Capital Advisors' managed equity separate account strategy. The composite does not include any non-fee-paying portfolios. The Capital Advisors Equity Composite inception date is 12-31-91.

Performance Figures (Net of Fees)

Equity Composite: Net of Fee returns are obtained by deducting brokerage commissions, management fees, and all other expenses. The Firm's composites contain accounts with different fee structures. Due to different account sizes, the fees represented may be higher, or lower than your own account. The Firm's fee structure can be found in Form ADV Part II.

Indices

The following indices are used for benchmarking purposes and do not necessarily represent the same diversification or weightings as the Firm's various composites:

S & P 500 is an unmanaged, capitalization weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. This index assumes the reinvestment of dividends and the percentage changes in the benchmark represent the annual percentage change of the index for the period reported. It is not possible to invest directly in this index.

Lehman Brothers Aggregate Bond Index is an unmanaged index made up of U.S. Government, corporate, mortgage backed and asset-backed securities rated investment grade or higher. It is not possible to invest directly in this index.

Other Disclosures

Additional information including management fees and expenses is provided on Capital Advisors' Form ADV Part II. The actual return and value of an account fluctuate and, at any time, the account may be worth more or less than the amount invested. Bond Investments are affected by interest rate changes and the creditworthiness of the issues held in the portfolio. A rise in interest rates will cause a decrease in the value of fixed income positions.

Past performance results are not indicative of future results.

Presentation is prepared by: **Capital Advisors, Inc.**

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