Lucien, Stirling & Gray Advisory Group, Inc.

# SECOND QUARTER REPORT 2008

July 2008


LUCIEN, STIRLING & GRAY ADVISORY GROUP

"Smart Decisions About Serious Money"

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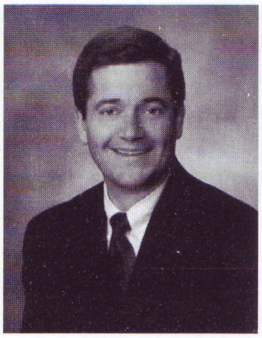
## A MESSAGE FROM THE PRESIDENT

*Thomas G. Twombly*



We are pleased to provide you with our report for the period ending June 30, 2008.

The quarter brought a continuation of the highly challenging environment we have been in since last fall. Markets as a whole improved during the first half of the period on hopes of improving economic conditions, and then abruptly gave back their gains during a particularly brutal June, as oil prices reached levels never seen before, and as the inflationary effects of their stubborn rise had the inevitable impact on consumer confidence. The health of large U.S. financial institutions continues to be a concern, and the effect of their overall weightings in broadly-followed U.S. equity indices was demonstrated during the period, as sharp drops in their share prices weighed heavily on results. Foreign markets also fell, as slowing economic growth and increasing inflation left investors unsure about central bank policy and the future level of interest rates.

The bright spot for the quarter proved, again, to be in the value of select oil, gas, and commodity holdings we hold for clients. As you will note from the commentary that comprises the second half of this report, and that accompanies your personal portfolio review, these holdings, along with fairly large overall cash holdings, helped most of the portfolios we manage to maintain slight gains for the period, while reducing overall volatility. While we continue to be pleased with relative results, we are also focused on carefully managing risk. Though many investors recently have been tempted to significantly overweight these areas, we opted instead to use recent price gains to take profits in many portfolios, rebalance assets, and add slightly to talented management teams in areas that have been under pressure.

As a firm, we continue to devote significant resources and effort to constant improvement. Tough economic times are when trusted advisors are most valuable, and we are determined to make sure that the quality of our communications and client service exceed expectations. As always, we would sincerely appreciate your candid feedback about our efforts, and your advice about ways in which we can improve in the future.

*"Tough economic times are when trusted advisors are most valuable, and we are determined to make sure that the quality our communications and client service exceed expectations."*

The most noticeable recent change is in our website: www.lsggroup.com. Launched in mid-June, it has been completely redesigned; with an updated look and feel that we hope is more reflective of whom we are as a firm. As a diverse team that has worked together for many years, and has developed a strong sense of internal trust, we hope to be viewed at once as warm, friendly, and approachable – and thoroughly reliable in the handling of our client's wealth management needs, however complex they may be. We would appreciate your help in assessing our progress towards that objective.

Towards that end, we are in the process of sending out surveys to all clients asking for feedback on a number of important operational and professional service issues. By the time you receive this report, you should have received such a survey, and we hope you will be willing to provide us with your candid advice. Ultimately, the success of a long-term wealth management plan is dependent on the quality of thinking that goes into the process by both the advisor and the client. Though we have a great deal of expertise about the technical aspects of investments and financial planning, you are the expert on your life. Your efforts will help us to maximize the possibility that those plans, and our professional efforts, will be successful.

Finally, I hope you'll join us in welcoming Patricia Hernandez to the Lucien, Stirling & Gray team. Pat joined us in February as my Executive Assistant, and comes to us with an extensive professional background, including experience in management consulting, and as a licensed financial advisor. Her warm personality and efficiency have helped her fit in here quickly, and we are excited to have her on board. Over time, she will be assisting us in all aspects of client service and business development, and I look forward to introducing you to her in person.

Thank you for your continued confidence and trust, and thank you for introducing us to colleagues and friends. Volatile financial markets and economic uncertainty often create anxiety, and many people are looking for an objective second opinion. We are grateful that so many of you feel comfortable recommending us. Please let us know how we can help.

Thomas G. Twombly

President

## CORE MODEL COMMENTS

**Conservative Growth Model:** As we had expected, financial markets remained volatile throughout the second quarter. The month of June was notably unpleasant for equity investors in general, with the Dow Jones Industrial Average falling in excess of 10%, and the S&P 500 declining by almost 8.5%. This put both of these widely followed indices firmly in the negative column for the quarter, and leaves both with double-digit declines for the year so far. Large-cap value companies as a group showed pronounced weakness, as financial stocks in particular were punished by deepening concerns about the health of their balance sheets, rising unemployment, and declining consumer confidence. Against this backdrop, the most conservatively managed of our core models performed well, experiencing considerably less volatility than markets as a whole, and producing a positive total return of .93% for the period. Natural resource holdings, once again, were the standout in the portfolio, as energy and commodity prices rose dramatically through the quarter. Overall cash holdings, which remain close to 30% of assets at quarter's end, helped to mitigate fluctuations, as did the portfolio's 21% allocation to bonds and convertible securities. Towards the end of the period, we took advantage of the substantial run-up we've experienced in the model's natural resource holding to lock in gains, and replace it with a multi-manager real asset fund. This allows us to keep an inflation hedge, but with a somewhat more diversified and conservative approach.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| 0.93% | -4.33% | -0.88% | 82.01% |

Inception Date 06/03/1999

**Core Growth Model:** With positive total returns of 1.1% for the quarter, this portfolio also has performed admirably during a period that has proven to be exceedingly challenging for investors around the globe. Though returns for the portfolio are still negative on a year-to-date basis (-3.93%) and on a trailing twelve-month basis (-1.42%) results remain well ahead of all broadly-followed equity indices, including the S&P 500, which has produced returns of -11.91% and -13.13% for the same periods. As is the case with most of our models, the portfolio has remained broadly diversified and defensively oriented since the middle of last year. With 18% of holdings directly in money market holdings, the portfolio closes the quarter with almost 38% of overall assets in cash and equivalents, reflecting a defensive posture among underlying managers. Notable gains for the period came from natural resource holdings, as oil and gas prices rose dramatically around the globe. Additional benefit came from stand-out performance from the portfolio's bond manager, and from the small-cap manager, who produced relative results far better than their peer groups. During the quarter, we took advantage of weakness in equity markets to begin adding slightly to existing holdings in Fundamental Investors, and towards the end of the period we opted to reduce overall holdings in natural resources as record oil prices provided an opportunity to lock in solid gains.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| 1.10% | -3.93% | -1.42% | 62.02% |

Inception Date 05/31/2003

**Growth Model:** The most aggressively managed of our core models also produced positive results for the period, providing total returns of .93% in an environment that most investors found daunting. More importantly, on a longer-term basis the portfolio continues to provide excellent risk-adjusted results. For the three year period ending June 30, 2008 the portfolio has generated average annual returns of 10.81%, and it has produced average annual returns of 13.7% for the trailing 5 year period. This compares very favorably to indices such as the S&P 500, which has produced average annual returns of 4.40% and 7.58% for the same time frames. Also defensively oriented since the middle of last year, the portfolio remains broadly diversified and mindful of financial markets that display considerable unease. With 17.3% of assets directly in money market holdings, the portfolio ends the quarter with slightly over 29% of assets in cash and equivalents, reflecting considerable cash holdings among underlying managers. As with our other models, towards the close of the quarter we took advantage of high prices in natural resources, which were a stand out in the period, to reduce holdings that had grown considerably since acquisition. We also took advantage of weakness in equity markets to begin building a small position in science and technology holdings, and to add slightly to an existing global asset position, areas we expect to do comparatively well in the future.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| 0.93% | -5.36% | -3.95% | 873.01% |

Inception Date 10/16/1992

## SPECIALTY MODEL COMMENTS

**Diversified Growth Model:** This portfolio, which is designed to remain fully invested in a broad spectrum of equity funds at all times, experienced declines of -1.06% for the quarter, bringing its year-to-date total return to -9.45%, and its trailing twelve month return to -11.03%. Though this has been a challenging time for an all-equity portfolio, selected managers have done an excellent job of staying ahead of markets as a whole, where broadly followed indices such as the DJIA and the S&P 500 have fallen in excess of 13% during the same period. On a longer-term basis, the portfolio has shown considerable strength, providing 5 year average annual returns of 10.95%, which has outstripped both of the aforementioned indices by more than 3% per year. Broadly diversified among equity style boxes, the portfolio is currently weighted towards growth, with 66% of overall assets invested in large and mid-cap core and growth companies.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| -1.06% | -9.45% | -11.03% | 51.83% |

Inception Date 10/31/00

## EDUCATION MODEL COMMENTS

**UT ORP:** Total returns of .46% for the quarter and -3.40% for the trailing twelve months have enabled this portfolio to stay well ahead of most broadly-followed equity indices for both periods, while keeping overall volatility significantly lower. On a longer-term basis, the portfolio has also provided excellent risk-adjusted results, producing 3-year average annual returns of 8.99%, and 5-year average annual returns of 10.0%, while limiting overall volatility to less than 70% of the S&P 500. Managed specifically for our clients who are participants in the University of Texas Optional Retirement Plan, the portfolio enjoyed particular benefit during recent months from its global bond holdings, and from its 8% overall allocation to a select natural resource fund. Additionally, above-average peer group performance from the portfolio's small and mid-cap value managers has contributed to relative performance gains. Currently with 40.5% allocated to U.S. equities, 23.7% allocated to international equities, 11% allocated to bonds, and the remainder allocated cash and cash equivalents, the portfolio is broadly diversified. Underlying allocations have remained largely unchanged since the last period, and we remain pleased with the ways in which select managers have the portfolio positioned.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| 0.46% | -4.64% | -3.40% | 56.70% |

Inception Date 08/10/1999

**Retirement Growth:** In a notable reversal from our first quarter report, the majority of managers in this portfolio produced results for the period that were better than their peers in many of our similarly managed models, and considerably better than financial markets as a whole. When combined with excellent comparative results from the newly selected mid-cap manager, and outstanding returns from holdings in oil, gas, and commodities, this portfolio provided positive total returns of 2.79% for the quarter, regaining much of the ground it had given up earlier in the year. Importantly, though the current environment is highly challenging, and though trailing twelve-month returns for this model are still negative (-4.04%), results are substantially better than broadly-followed indices such as the S&P 500 or Wilshire 5000, which have declined by 13.12% and 12.46% respectively during the same time frame. During the quarter, the investment policy committee elected to replace the Fidelity Value Fund with the Fidelity Leveraged Company Stock Fund, which proved beneficial to results. Towards the end of the period, we added a new position of approximately 5% of overall assets to the New Markets Income Fund, bringing bond holdings up to 11% of portfolio assets, and providing an additional level of diversification to the portfolio.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| 2.79% | -4.44% | -4.04% | 96.52% |

Inception Date 06/03/1999

**Growth & Capital Preservation:** Managed specifically for our clients who are participants in various higher education retirement plans, this portfolio is designed to provide conservative long-term growth, with a careful eye towards limiting downside risk. In a highly volatile period, where many investors have experienced gut-wrenching volatility and steep losses, we are pleased to report that this portfolio continues to perform admirably. Total returns for the recent quarter of 1.52% have helped to regain much of the declines experienced in the first quarter, and bring the portfolio's trailing twelve-month results to -2.72%. In a market environment where all widely-followed equity indices have fallen between 10% and 16%, we are pleased with overall results. Holdings in the Fidelity Canada Fund, which invests heavily in natural resources, were of particular benefit to the portfolio in recent months, as were holdings in inflation-protected securities. Longer-term results also remain admirable, with the portfolio generating average annual returns of 8.9% over the last five years, while maintaining risk levels substantially below those of stock markets as a whole.

| 2nd Quarter | YTD | One Year | Lifetime |
|---|---|---|---|
| 1.52% | -2.76% | -2.72% | 54.47% |

Inception Date 11/30/2001

## Upcoming Events

*Fireside Chat:*

September 18, 2008
6:30 – 8:00 pm

## General Market Results

| | *2nd Quarter* | *YTD* | *One Year* |
|---|---|---|---|
| *CPI* | 1.45% | 3.14% | 3.97% |
| *DJI* | -6.85% | -13.38 | -13.27% |
| *Nasdaq* | 0.61% | -13.55% | -11.92% |
| *S&P 500* | -2.73% | -11.91% | -13.12% |
| *Russell 2000* | 0.58% | -9.37% | -16.19% |
| *MSCI World ex US* | -0.86% | -9.84% | -6.20% |
| *LB Agg Bond* | -1.02% | 1.13% | 7.13% |

Lucien, Stirling & Gray Advisory Group, Inc. is a Registered Investment Advisory firm providing fee-based asset management and planning services to individuals, corporations, trusts and foundations.

*For more information about our firm, please visit our website at www.lsggroup.com • Model holdings may change due to ongoing management • Sector and style breakdown is constructed with the best available information and therefore is only as accurate as the available information • Past performance is no guarantee of future results • It is impossible to invest directly in indices • Percentages may not equal 100 due to rounding*

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