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CAPITAL MANAGEMENT

July 2008

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Market Update

Financial markets were roiled in the second quarter of 2008, as the economy continued to slog through the worst credit crisis in nearly a generation and tried to acclimate to skyrocketing energy prices without yet showing the official contraction that is the hallmark of recession (a recession is popularly defined as back-to-back quarters of falling gross domestic product). After an initial surge and subsequent plunge, the Standard & Poor's 500 registered a 2.7% drop for the quarter and was down 11.9% for the year to date. Even the bond market did not escape the climate of uncertainty, with the Lehman Bros. Aggregate Bond Index dropping 1.0% for the quarter. Commodities, such as oil, food, steel, and fertilizer, represented the lone prosperous corner of the market. This commodity rally was however a major source of alarm for other asset classes. Oil prices surged over \$140 per barrel, contributing to the economy's woes and to the difficulty of Federal Reserve Chairman Bernanke's position. Economists define inflation as the condition of more money chasing the same amount of economic output. However, there's little doubt that higher energy costs are rippling through the economy and that consumers have been feeling pinched after filling their gas tanks, leading to worries of a return to 1970s-style "stagflation." Although the Fed kept the short-term interest rates that it controls relatively low, there was no safety in bonds. The bond market experienced a sell-off, driving longer-term yields up as investors anticipated inflation and future rate increases. At this point, markets seem to have baked all this bad news into security prices, so even small improvements in macroeconomic and corporate health could spark a strong comeback. Pessimism surrounding broad asset classes seems overdone when looking over the long term.

Nothing since the bear market of 2000–2002 comes close to the slate of multiple threats that markets are dealing with right now. A weak dollar, a slumping housing market, distressed financial institutions, consumers and corporations squeezed by record fuel and input prices, job losses—all point to the risk of a prolonged slowdown in the U.S. economy. After all, when Japan experienced a similar collapse in property prices and bank loans in the early 1990s, the country went through well more than a decade-long slump.

Markets do have a couple of key advantages to battle this crisis, however. Broad swaths of the corporate sector outside the financial services arena are in relatively solid financial health, with cash saved up from the strong run in corporate profits until the crisis hit. Moreover, the "decoupling" thesis, which claims that emerging markets can sustain their streak of robust growth in the face of a slowdown in the U.S., does have some basis. In that scenario, demand from emerging markets would keep the global economy and corporate profits from a more prolonged downturn. Indeed, U.S. companies geared to the global economy have continued to report surprisingly strong earnings.

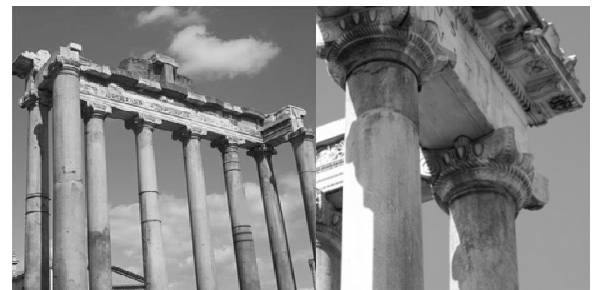
Until the credit crisis broke last year, all manner of risk-taking was handsomely rewarded. High-yield bonds, small-cap stocks, highly leveraged debt instruments etc. were all paying off, and investors did not need to be very discriminating in picking through risky assets. It is probably safe to say that we have entered a different era now, one in which investors will need to take more calculated risks.

Inflation Protection

Inflation has been a relatively stale subject for the last decade. The U.S. economy experienced prolonged periods of growth while only confronted with lower levels of inflation, generally at or below 3% annually. The recent rapid rise in commodity prices, most notably food and energy, has brought inflation back into the 4.5% - 5% range which is above historic averages. What are the best ways to protect your portfolios from inflation? The three best investments to battle inflation are stocks, real estate, and TIPS (Treasury Inflation Protected Securities). Most all Taurus Capital Management clients hold at least two of these investments if not all three. Beating inflation is critical in preserving your purchasing power in the years to come.

Stocks are the single best inflation fighting investment. Since 1926, stocks have averaged annual returns of 11% versus inflation at 3%. While stocks are more risky than bonds or cash, that 8% real rate of return has been second to none in protecting purchasing power. Real estate is also seen as a good inflation hedge as landlords and property managers look to raise rents with increases in pricing through the economy. The higher cash flows produced by real estate holdings increases the value of real property. Furthermore, with increases in building materials caused by inflation, the replacement costs of constructing homes and other buildings increases the price demanded at final sale. TIPS are another tool for fighting inflation. Unlike typical bonds that pay a fixed coupon and principal amount at maturity, the principal and coupons of inflation-protected bonds are periodically adjusted upward (or downward) with changes in the Consumer Price Index (CPI).

While the current economic environment is unsettled, the long term earnings power of stocks and real estate and the hedging benefit of TIPS will allow your portfolios to stay ahead of inflation over the long term.





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Education Corner

There is an often-stated claim in the financial services industry and its ubiquitous advertising stating that active (as opposed to passive) mutual fund managers investing in so-called “inefficient” markets have an easier time outperforming an index. Conventional wisdom states that investment managers have special insight into these markets, which allows them to pick winning stocks over and over again. That translates into higher returns in their funds—and justifies the high fees they charge.

Problem is, the data does not support the claim. In fact, beating an index is just as difficult in an “inefficient” market as it is in any kind of market. There certainly are skilled mutual fund managers who perform better than an index, but not simply because they happen to be invested in any particular asset class.

What is market “inefficiency”? What exactly are “inefficient” markets? Finance experts use the term to describe markets where basic information about companies may not be available to investors. For example, many small-cap, international, and emerging market companies are not widely followed by analysts or other investment professionals in the United States (in contrast to most large-cap U.S. companies). This means stocks that are over- or undervalued can go unnoticed for some time, which translates into more opportunities for active managers to outperform the index. Because less efficient markets have greater volatility—they have higher highs and lower lows—it also means larger consequences if the manager is wrong.

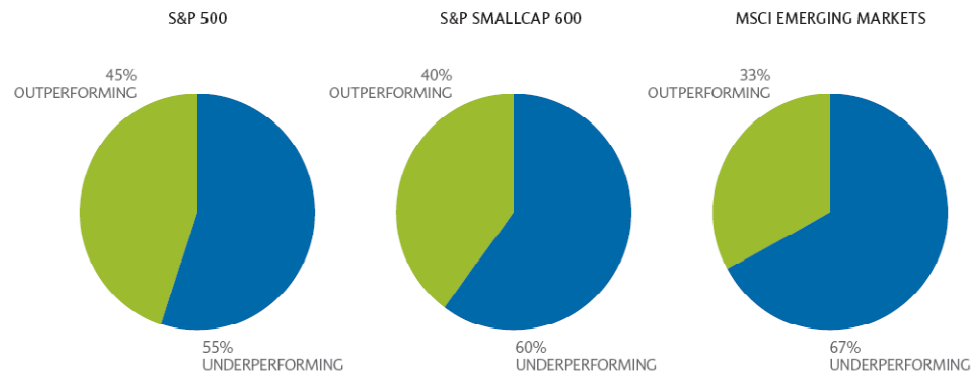
It’s not enough for such “mispricings” to simply exist. Investment managers still need to find them before others do. While some truly skilled managers can take advantage of more opportunities in these markets to beat an index, not all of them can.

Looking at the record

The fact that there is no magic wand in inefficient markets when it comes to stock selection, and thus manager selection, is supported by the actual record of active mutual fund managers investing in those markets.

Figure 1 shows the percentages of active managers — in both efficient (S&P 500) and less efficient (S&P Small-Cap 600, MSCI Emerging Markets) markets — out or underperforming their respective indexes for the last 10 years.

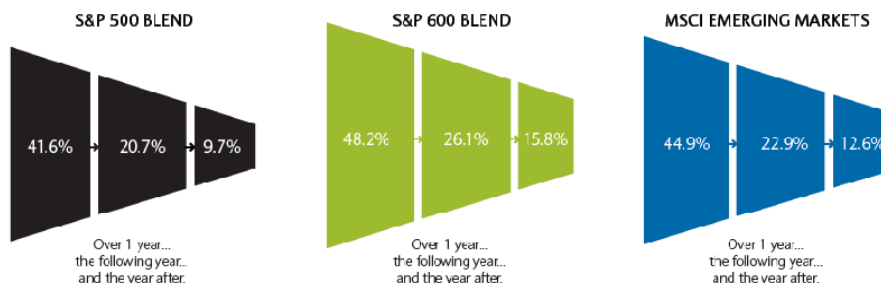
FIGURE 1
10-Year Annualized Return Comparison for Active Managers vs. Category Benchmark



Sources: BGI, Morningstar, MSCI Inc., S&P, as of 12/31/07.
Past performance is no guarantee of future results.

Clearly, some managers may have skill in identifying mispriced securities in less efficient—or efficient—markets, but most do not. And it is important to remember that fees in less efficient markets are generally higher, making it even more challenging for an active manager to outperform an index in this environment. Even if a manager beat an index in a particular year, how do we know if he or she was truly skillful, or simply lucky?

FIGURE 2
Persistence of Skill—active managers outperforming their respective benchmarks in consecutive years.*



Sources: BGI, Morningstar, MSCI Inc., S&P, as of 12/31/07.
Past performance is no guarantee of future results.
*Average for the period 12/31/92-12/31/07.

Perhaps they made the right stock picks, but for the wrong reasons. If so, it is doubtful their luck will last for very long. Indeed, as Figure 2 illustrates, the chance of a manager’s continued outperformance falls dramatically for each subsequent year across all three asset classes.

The chance of continued active manager outperformance falls dramatically each subsequent year across all three asset classes.



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Taurus Capital Management is here to guide you through these difficult times and to help you understand and maintain perspective on the markets. While it is always more fun to see the markets going up, volatility is to be expected. If you ever have questions, please never hesitate to contact us. We always remember that you have entrusted us with your hard-earned savings and we work tirelessly to protect and growth your wealth with prudent and time-tested methods.

The indexing solution

An index is intended to represent a given market or market segment. It can be as broad as the entire U.S. stock market, or as narrow as a single country or industry. And numerous indexes exist for efficient and inefficient markets.

Index-based investing offers several benefits, including typically lower costs than most active management strategies and benchmark-consistent performance. In addition, index funds are broadly diversified since they typically hold all or almost all of the securities within the index. This "instant" diversification helps reduce portfolio risk. Taurus Capital Management has always relied on indexing as a more precise, less expensive way to access particular asset classes, including "inefficient" ones.

Taurus Capital Management and Passive Investing

As you know, Taurus Capital Management's methods are based on passive index-based investing methods. Although good active managers exist, identifying them in advance is challenging. More importantly, given the uncertainty that will always surround performance of even the best active managers, it makes sense to use them in combination with index funds to more effectively manage risk within a portfolio.

Finding the right balance of index and active funds for your particular investment needs and goals can be very difficult. Your Taurus Capital Management financial professionals are here to help you navigate the investment selection process by focusing on the right blend of investments for your needs.

Taurus Capital Management & the Community

We not only work here, we live here.

Taurus Capital Management continued its efforts to give to the community in the first half of 2008. We will always take a responsible role in giving back to the community. Thus far during the 2008 fiscal year, Taurus Capital Management has proudly donated to the following organizations:

Deschutes Children's Foundation
Loaves and Fishes (Meals on Wheels)
Pacific Crest Community School
Portland Hope Meadows
Portland Youth Philharmonic
The Leukemia & Lymphoma Society



Pacific Crest
COMMUNITY SCHOOL



PORTLAND YOUTH PHILHARMONIC



The Leukemia &
Lymphoma Society
Fighting Blood Cancers



Deschutes Children's Foundation



LOAVES & FISHES CENTERS
The Meals-On-Wheels People



Thank you for being a valued client of Taurus Capital and for making such donations possible.

As always, earning your continued confidence and trust in Taurus Capital Management is the cornerstone of all we do. Please feel free to share this newsletter with anyone who may be interested. Referrals are always welcome and appreciated!

Gregory G. Saliba
Principal