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Before reviewing what 2008 might hold in store for us, it could be worth noting how 2007 fared. After a pretty volatile year, the S&P 500 was up 3.5%, the Dow was up 6.4%, and NASDAQ was up 9.8%. Most of you will notice that your equities did quite a bit better than that. The bulk of our gains were made in three months—May, August and September. That isn't unusual. It's fairly typical to see your gains come in little clusters like that.

What is interesting is to compare this result to the common wisdom. If you believe in market lore, those three months are supposed to be among the worst months to be in the market. "Sell in May and go away" has been quoted for years among academics and market pundits. They point to all sorts of studies showing that the market from November through April frequently has better results than the period from May through October. From this they conclude that you would be better off being fully invested every November, selling everything at the beginning of May, and then getting fully invested again in November.

I'm not sure how they get from the facts to their conclusion.

Walk through this slowly. In order to conclude that we would all be better off selling every May and buying every November, we would have to agree on a lot of prerequisites. First, we have to assume that everyone owns a market index fund, and then we have to assume that owning this index fund is the only available choice. Next, we have to assume there are only two possible courses of action---that you have to choose to EITHER buy that fund one time and never buy or sell again, OR choose to select one day each year on which you will sell the entire fund, and choose another date in each year on which you will buy it all back.

If all of those things are true, then we need to compare every other combination of buy/sell dates. We know that the person who chose the dates of May 1 to sell everything and November 1 to buy it all back every year would have done better in most years than the person who bought once and was never allowed to buy or sell again for any reason. Only if all of the other factors are *also* true, can we conclude that we should follow their example.

Do you see the problem? Only two very limited strategies were compared out of the *millions* of strategies that were available choices. Two. How can you draw conclusions or frame strategies about the market based on that? That is why we do not incorporate market lore into our investment discipline.

I have always thought that it was a better idea to "listen to the market" and invest accordingly. Add in a healthy dose of common sense, and your results improve even more.

The sub-prime mortgage fiasco was there for all to see for many months, even years, before it all came apart. The resulting credit crunch, loss of faith in the banks and regulators, slowdown in new construction, foreclosure rates, falling home prices and slowing sales were the obvious conclusions to the story. That's why banks, savings and loans, real estate, home builders, mortgage lenders, and Wall Street had all been sold from your portfolios. Without the drag from those areas, it was much easier to get good results.

2008 will not be so easily predictable. For one thing, it's a presidential election year with no incumbent running for re-election. That means that whoever wins will believe that they have some sort of a mandate from the voters to translate their ideas into policy. That introduces uncertainty into the picture. At this point, no one knows how to prepare for these anticipated changes, because we have no idea what sorts of changes will occur. That uncertainty makes investors nervous. It's much easier to play by the rules when you know what the rules are going to be.

Maybe more importantly, volatility follows disruption, and the sub-prime debacle has surely caused disruption. This is basic human emotion at work. We all feel more secure when we feel that the world is behaving in accordance with our beliefs. If the rules we trust as dependable are suddenly changed or proved faulty, then we take action to protect ourselves. If terrorists unexpectedly attack us, we change our stance from passive to defensive and we hit back. When we see our home values unexpectedly deteriorate, we shy away from new purchases of real estate. When we lose faith in the banks and the regulators, we stop buying bonds and we stop believing the rating agencies. When we see unprecedented bankruptcies and foreclosures, we stop lending money.

These sudden shifts in our attitudes about what constitutes "security" cause movements of money out of one place and into another. This movement of money does not flow in an orderly or predictable manner. It hops and jumps and stumbles and surges and plummets. In addition, when you have to sell, you can't always sell what you want. Sometimes you have to sell what you can. (There has to be a buyer.) This combination of events is where the volatility in prices comes from. It stabilizes again once everyone has rearranged their assets in accordance with their new attitudes regarding security.

2007 showed volatility and I think 2008 will as well. There is still a lot of money in motion, trying to find a spot that feels more secure than wherever it has been. Where will it go? For reasons discussed in previous letters, an awful lot of it will wind up in the stock market. If I had to guess, I would guess that the market will have a bumpy, but pretty good year. But it doesn't matter what I would guess. We do not own the market. We all own just our tiny little slice of the market that looks the most appealing at the moment. As always, I will continue to follow the indicators that have led us so well so far.

This is what I do know about 2008. There has been a visible shift in market leadership away from small cap and value and toward mid-cap and growth. Having led the market since 2000, this represents a very significant change.

It's time for a move into technology, whether seen in computers, healthcare, energy, business, waste management, food preparation, protection, or any other area. Oddly, basic materials still seem to be an area of interest. You will have been seeing some of these changes in your portfolios, and will continue to see them as we move farther into the year.

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