Mengis
CAPITAL MANAGEMENT INC.

Mid-Quarter Newsletter

August 15, 2008

From My Corner

Jeff Mengis – President

It's hard to believe that another beautiful Pacific Northwest summer is coming to a close and making way for fall. I hope you have been able to enjoy the summer with your family and friends. Sunriver seemed to be the vacation spot of choice for the Mengis office this year. Cindy made her trip with the family to Sunriver in July, while I visited with my family in August. Both of us had a great time with our families playing tennis, riding bikes and exploring. It's hard to believe that it's already time to send the kids back to school.

The end of summer also means that traders on Wall Street are returning to work and reevaluating their investments. As you may know, the continued financial turmoil has resulted in a flight to quality which has caused investors to buy treasuries, sending the 10-year bond yield lower to 3.9% and the 2-year note down to 2.4%. Declining treasury yields have led to lower yields in money market funds (MMF). For example, the Schwab Prime Reserves MMF, is yielding approximately 2.1%.

Fortunately, there are options available for those seeking more cash flow from their assets and are willing to take some additional risk. Select corporate bond yields are looking more attractive when compared to MMF yields. We recently bought investment grade corporate bonds without financial sector exposure in the 2012-2013 maturity range that are yielding around 5.25-5.75%. This area of the yield curve offers attractive returns while providing less volatility when compared to long-term bonds. In addition, as part of a diversified fixed income portfolio, we have been adding to positions of the Goldman Sachs Hi Yield Bond Fund yielding about 9%. If you have a CD maturing soon, or money earning a lower interest rate, you may want to contact us to discuss these fixed-income options.

In the meantime, I hope you have had a good summer to date and are able to enjoy the warm weather while it lasts.

Investment Focus:

AT&T (T) is one of the largest telecom providers in the world and the largest in the U.S. Its sales in 2007 were split between landline voice (34%), data (20%) and wireless, etc. (46%).

During the last quarter, wired revenue fell 2.1% year-over-year while wireless segment revenue rose by 15.8%, fueled largely by a 52% increase in wireless data revenue. That revenue growth illustrates why customers that use 'smartphone' mobile devices with the ability to surf the web are the most desirable users among telecom companies. We think AT&T has a considerable competitive advantage because it has the exclusive rights to the hottest smartphone around: Apple's iPhone.

We feel the iPhone will be a long-term success and that AT&T is one of the best ways to benefit from iPhone sales. The iPhone is essentially a phone, computer, video device and music player in one that has exclusive access to Apple's iTunes music and video library. AT&T did not benefit as much as hoped from sales of the original iPhone, because many phones sold were never connected to AT&T's network. In order to ensure that iPhones are used with the AT&T network, AT&T has subsidized the initial price of the new 3G iPhone from $399 to $199 for customers signing a 2 year contract. The 3G iPhone sold over 1M units in its first weekend and some analysts predict worldwide iPhone sales of 45M through 2009. The initial subsidy cost to AT&T will be high, but we feel AT&T will be rewarded over the long-term with high-margin, loyal customers.

The stock is trading at 9.5X forward earnings, toward the bottom of their 5 year valuation range. This lower price is due to fears that AT&T's wired phone business is shrinking and higher marketing costs have reduced margins for their wired bundle service "U-Verse". We feel those concerns are adequately priced into the stock. With consensus earnings growing at around 10% for the next few years and a 5% yield, we believe AT&T is a good buy.

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