



February 12, 2007

Dow: 12,635

SWITCHGRASS

The new bio-fuel. Centuries ago switchgrass dominated the Great Plains of America before the coming of mass humanity, railroads and the steel plow. Switchgrass is fast growing and tough. It can reach ten feet in height. It captures lots of solar energy turning it into chemical energy – cellulose – that can be liquefied, gasified or burned directly. Studies have shown that switchgrass can produce an average 11.5 tons per acre which translates into 11,500 gallons of ethanol per acre. Switchgrass is a hardy perennial (for ten years or more) and can be harvested by standard farm equipment. Switchgrass can reduce erosion and remove pesticides and fertilizer residues from surface water. It also removes carbon dioxide (CO₂) from the air as it grows, thus slowing the buildup of greenhouse gases in the earth's atmosphere, and unlike fossil fuels which simply release more and more CO₂, switchgrass simply recycles CO₂ over and over again.

US ethanol production from corn currently totals nearly two billion gallons a year. However, producing ethanol from corn requires almost as much energy to produce as it yields. Ethanol from switchgrass can produce about five times more energy than is put in. In effect, the net energy output of switchgrass is about twenty times greater than corn's. Also, the poor are marching in the streets in Mexico because their corn-based tortilla prices are escalating. Corn as a feeder will also tend to raise beef and poultry prices.

President Bush is planning a trip to Brazil to seal an ethanol pact signed last week to supply fuel from switchgrass and other sources. The ultimate goal is to create a commodity market and undercut OPEC's monopoly and especially Hugo Chavez's abusive policies. The US and Brazil together produce 70% of the world's ethanol and could create a market. Now, this may not be the answer to energy independence, but it is a step in the direction of on-going research that will ultimately lead to a solution.

In a related news item, Exxon Mobil just reported a profit of \$39.5 billion. That is the highest profit of any corporation in the world. Already Congress is lining up to "take" some of those profits and put them in an alternative fuel fund. Somewhat like the Social Security fund where it could be used for all sorts of pork. However, if you look closely at the numbers, you will see that those profits came on sales of \$377.5 billion which works out to a profit margin slightly over 10%. Contrast that with many companies in the banking, hi-tech and bio-tech industries that have profit margins double that of Exxon Mobil. According to

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the Tax Foundation, Exxon Mobil paid \$100.7 billion in taxes last year. Further, over the past twenty-five years federal and state governments took \$397 billion from the largest oil companies and an additional \$1.1 trillion in taxes at the pump. That's a lot of money generated for the federal and state governments. Add on to that the jobs created and the additional tax revenue generated by those jobs and spent or invested by the consumer. Shareholders also gain through dividends and capital gains. You can bet that the major oil companies know that the days of fossil fuels are coming to an end and much of their profits are being spent on research for alternative fuels. Better they use the money than the federal government. Why do we choose to punish success? Success lifts all boats.

Many of our clients own pools of adjustable rate mortgages and with interest rates rising, the coupons on many of these pools have exceeded the 7% level, and if rates remain stable or even rise, these coupons will adjust higher. We have had a few questions concerning the rising default ratio on home mortgages. First of all, those defaults, or late payments, are primarily centered on sub-prime loans – those issued to borrowers with a shaky credit history. We do not purchase these loans. We only purchase pools of government backed and government agencies which have much higher underwriting standards. Prepayments on these ARM pools are also slowing, as other lenders are tightening their standards due to the over supply of houses on the market and to declining prices. It is also becoming more difficult to refinance ARMs in the current market environment, and with fixed-rate thirty-year mortgages near 6.5%, there is not much incentive to refinance. In sum, the ARM market is currently offering attractive returns for conservative portfolios.

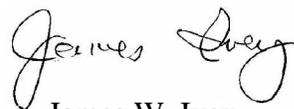
Random thought for February 2007:

“Yesterday thousands of Mexicans gathered in Mexico City to protest food prices. The protest only lasted an hour because everyone had to leave for their jobs in Los Angeles.”

Conan O'Brien



Michael L. Dana
Chairman of the Board



James W. Ivey
President

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