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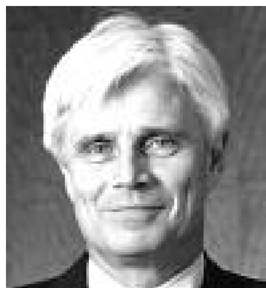
A Quarterly Review of Economic and Market Developments
3RD QUARTER 2007

BAILARD INTERVIEW

The Investment Outlook in a Post Credit-Crunch World

During the third quarter of 2007, the global financial markets hit some serious bumps due to the U.S. subprime mortgage meltdown, a pullback in private equity lending, losses in prominent high yield and "quant" hedge funds, and ultimately a "credit crunch" and the repricing of risk. Below Peter Hill, Bailard's Chief Investment Officer, discusses recent events and their effect on the investment outlook.



Peter M. Hill
Chief Investment Officer

What caused the credit crunch?

The crisis began with increased defaults on subprime mortgage loans and quickly spread from subprime lenders to hedge funds, banks and other institutions around the world that had invested (sometimes on a leveraged basis) in securities backed by this debt. The problem was exacerbated by a lack of transparency over just who was exposed to this credit risk. In August, mounting investor anxiety led to numerous sell-offs, a pullback in private equity lending and ultimately a credit crunch as liquidity for any type of risky lending evaporated.

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The investment outlook in a post credit-crunch world

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The equity markets seem to have rebounded in September from the downdraft in August. Is the credit crunch a serious problem or was it just a tempest in a teacup?

The credit crunch is likely to have some potentially serious negative consequences as well as some very positive effects. On the negative side, as a result of the deterioration in the quality of subprime loans and a reappraisal of risk (particularly for asset-backed securities), some of the conduits of liquidity to the market have been temporarily blocked or frozen. It will take time to free up the liquidity pipes again. The emergency plumbers: the Fed, the European Central Bank (ECB) and belatedly, the Bank of England (BOE), have rightly come to the rescue to keep liquidity flowing. The central bankers have been able to do this with relatively clear consciences, because there is scant evidence of a revival of inflationary pressures. The consequences of the credit crunch on the global economy are hard to quantify; certain projects and transactions, particularly in the U.S. and Europe, will be delayed, re-priced or cancelled. Almost certainly the global economy will slow a little. Since the credit crunch has exacerbated the woes of the housing market, a slower U.S. economic growth rate of between 2% and 3% now seems likely for the remainder of the year.

We think global equities fully merit their place in our pursuit of the perfect portfolio.

But a number of positives have also come out of the credit crunch. First, the central banks have shown their ability to step in and effectively perform their function as lender of last resort in a crisis. Second, interest rates have been cut significantly in the U.S., and European rates are now much less likely to rise. Lower interest rates should help rekindle economic activity. Third, a reassessment of risk can be healthy for financial markets. It makes bubbles less likely. Fourth, the wider global economy is sound and the emerging economies, in particular, have demonstrated their new found economic and financial viability by not being dragged into the malaise of abuses and excesses originating in the U.S. economy.

So looking forward, do you remain optimistic about the outlook for global equities?

Yes. We think that, with the Fed's further help if necessary, the U.S. economy will slow but avoid recession. Since China is now playing a significant role in helping to grow the world economy, we may be entering an era where the old adage "when the U.S. sneezes, the rest of the world catches a cold" no longer applies. Earnings growth has remained strong on a worldwide basis and price-earnings ratios are still attractive. Of course, we do have some concerns. In the near term, equities have technically moved ahead too fast and may need to pause for correction. Looking further ahead, as we approach the U.S. election of November 2008, uncertainties surrounding possible tax increases may weigh on the market.

What about equities versus other assets?

Over the last few years, some of the largest endowments and foundations in the country have successfully embraced a more aggressive investment approach: investing heavily in private equity, hedge funds and venture capital while reducing exposure to traditional public equities. As a result, many large public and private pension plans have been moving their portfolio allocation targets towards a larger exposure to these alternative investments. Events in August have abruptly reminded these institutional investors that the private markets are often opaque and that the obverse of higher rewards is a greater risk and a lack of liquidity. Over the next few months, it is likely that some of the fund flows earmarked for private investment will be steered back to the more transparent, liquid public equity markets (both U.S. and overseas). Such fund flows could be a fillip for public equities.

Our crystal ball is often misty. We are staunch believers that a diversified portfolio can cope best with future uncertainties. Nevertheless, from today's vantage point, despite many ongoing risks, we think global equities fully merit their place in our pursuit of the perfect portfolio.

We expect the U.S. economy to slow without slipping into a recession

U.S. economic growth accelerated from an anemic 0.6% in the first quarter to a greater than expected 3.8% in the second quarter. Although the third quarter started off on a strong note, the economy hit a brick wall in August and September due to the subprime mortgage debacle. As a result, we believe growth in the second half the year will be slower than we originally expected but not slow enough to drag the economy into a recession. Consumer spending and exports should offset the weakness in housing.

The consumer remains surprisingly resilient

Despite continued deterioration in the housing market and financial market turmoil, the consumer remains in good shape. Overall net worth is high. Personal income is growing at 6.8%, well above the personal consumption inflation rate of 1.8%. This should provide a strong foundation for consumer spending, which is rising at a 5.2% year-over-year pace. Initial unemployment claims are hitting new lows, layoffs remain extremely low, and job security is strong. Employment growth did slow in August due to the credit crunch. Employment numbers, which are lagging indicators, are likely to remain soft for a few more months, but swift action by central bankers has quickly helped to restore confidence. If the credit problem can stabilize (and early indicators are that it has), employment growth should reaccelerate.

Strong exports are boosting the corporate sector

Manufacturing has seen some slowing as a result of the credit crunch. However, strong global growth and a weak dollar have helped to boost exports by almost 15% year over year. Dollar weakness increases the attractiveness of U.S. goods and helps boost foreign profits translated back into dollars. As the current credit problems subside, we believe domestic production and capital spending are likely to ramp up again. Corporate profits remain strong and continue to provide positive surprises. Strong profits are one of the best leading indicators of overall growth and capital spending.

Housing is weak

Housing remains in a deep hole, with home sales continuing to slip and credit availability drying up for many buyers. While housing probably has further to slide, conditions may be setting up for a market bottom. Fed easing, lower rates, lower home prices and builder incentives should help increase housing affordability. After two years in recession, pent-up demand for housing is building. A simple stabilization of the housing sector at current levels could remove a 1% drag from GDP.

The Fed is likely to remain vigilant about credit market conditions

As a lender of last resort, the Fed had to step in last August and September to prevent the credit crunch from eroding financial confidence and undermining the overall economy, So far, the Fed's actions appear to be having a favorable impact. Credit spreads have started to narrow, stock prices have rebounded sharply, and option volatility pricing (a measure of risk) has subsided significantly. Banks and other financial institutions are aggressively writing down debt and increasing loan loss provisions in an attempt to put the problem behind them as quickly as possible.

However, the financial risk to the economy is not over. If housing continues to deteriorate, more problems could lie ahead. Even if housing stabilizes, banks are likely to be less willing to lend until they can resell the large overhang of debt (including leveraged buyouts) on their books. Investors burned by inaccurate rating agency assessments of credit risk may require higher risk premiums to purchase securities. Finally, close scrutiny by regulatory agencies and politicians is likely to make the financial sector more cautious in the short term.

As a result, we believe the Fed's bias will be to err on the side of ease. Historically, once it changes direction, the Fed typically pursues the new course for many months or even years.

Consumer spending and exports should offset the weakness in housing.

Led by Asia (ex-Japan), international economies are continuing to grow

Today, Asia has been the strong link in the global financial system.

Many foreign economies, particularly emerging markets, continue to provide positive growth surprises. European growth is mixed, but on balance slowing. Japan continues to stagnate.

European growth is slowing

The strong euro is hurting European exporters. A shrinking trade surplus is pulling down overall manufacturing activity and economic growth. Business confidence is declining and new orders are soft. The credit crunch has also contributed to the slowdown. Although the ECB is leaning toward tightening due to inflation concerns, higher interest rates could turn a slowdown into a recession.

The biggest problem may be that inflation, although low, is starting to increase and differs greatly across Europe. Germany's 2.7% inflation rate is well above the ECB's 2.0% target, while France's inflation rate is below 1.5%. Divergences in inflation rates make it hard for the ECB to set the right monetary policy. The central bank could raise rates again since it has typically erred on the side of controlling inflation. Nevertheless, we believe the ECB is near the end of its tightening cycle.

France's new President, Nicholas Sarkozy, is seeking to implement free market reforms. He recently argued for the elimination of France's 35-hour work week, calling this program "a monumental economic mistake" that resulted in the sharing rather than the creation of jobs. Sarkozy also wants to end mandatory weekend shop closures and to cut taxes. He has argued that "directly taxing production, work and capital is to condemn us to less work, less production, less growth and less purchasing power." Sarkozy's policies, if adopted, should increase the prospects for stronger economic growth, lower unemployment and a favorable investment environment in France.

Japan continues to struggle

With domestic growth stagnating, Japan's economy remains dependent on exports. This makes it difficult for the Bank of Japan to move away from its zero interest rate/weak yen policy. Domestic growth is being depressed by limited employment growth, slow wage growth, weak construction activity, declining housing starts and low capital spending.

Uncertainty regarding government policy is also undermining growth. Prime Minister Shinzo Abe resigned in September and has been replaced by 71-year old Yasuo Fukudo. The return of another old guard LDP, high tax, tight money, anti-reform politician is hardly exciting news from an economic or investment perspective. With Japan still flirting with deflation, we believe Japanese officials should be talking less about raising interest rates and taxes, and more about keeping liquidity flowing and encouraging political reform.

Japan's strength lies in its accessibility to emerging Asian markets, its educated and dedicated workforce, and its technological prowess. Many Japanese companies will likely do well in the current environment. However, the Japanese economy itself is likely to continue to struggle.

Asia ex-Japan is booming and decoupling from the West.

Ten years ago, Asia was in crisis as currencies plunged and investors scrambled to the safety of Western assets. Today, Asia has been the strong link in the global financial system. Throughout the recent financial market turmoil, Asian economic growth and stock markets have held up better than other global economies and markets. Low nominal interest rates, negative real rates and undervalued exchange rates continue to support growth. Although exports to the West have been strong, a growing amount of Asian trade is now intraregional as domestic economies (particularly in China and India) continue to expand. Economic data suggests this region's expansion may continue to accelerate. Stock prices have moved to new highs reflecting strong growth prospects, while industrial commodity prices, precious metals and shipping rates are also rising.

U.S. Treasuries were the best performing bonds in the third quarter

The subprime risks that roiled the fixed income markets in the second quarter morphed into a broader credit and liquidity crisis during the third quarter.

In the second quarter, yields rose across the curve as the U.S. economy showed signs of stronger growth despite weakness in the housing sector. But investor sentiment began to turn negative in mid-July due to renewed concerns about the impact of subprime mortgage defaults on anyone with exposure to this debt. The ensuing credit crunch led to a sharp increase in demand for risk-free U.S. Treasury debt. The yield on 30-year U.S. Treasury bonds fell from 5.3% in mid-July to a low of 4.6%, before ending the quarter at 4.8%. At the height of the credit crunch, the gyrations in the short-term fixed income market were even more telling of the markets' anxieties. The yield on the 30-day U.S. Treasury bill temporarily dropped from about 4.75% on August 9th to 1.5% on August 20th due to the flight to quality.

Supported by falling rates and a demand for risk-free assets, U.S. Treasury debt led domestic bond returns for the quarter. The overall market as measured by the Merrill Lynch U.S. Corporate, Government and Mortgage index advanced 3.0%, with Treasuries (Merrill Lynch U.S. Treasury Master index) increasing 3.8% and corporate debt (Merrill Lynch U.S. Corporate Master index) rising just 1.8%. High yield debt, which for several years had been one of the top performing sectors, was the worst in the quarter, returning just 0.4% according to the Merrill Lynch U.S. High Yield Cash Pay index. Tax-exempt debt, affected by a mixture of credit concerns and fears of lower tax revenues, returned 1.7% for the quarter, as measured by the Merrill Lynch Municipal Master index.

Credit crunch forced Fed to change policy

From June 2004 through June 2006, the Fed very carefully and deliberately increased the Federal Funds rate 25 basis points (0.25%) at each of its Federal Open Market Committee meetings, gradually restricting credit as short rates rose from 1.00% to 5.25%. The central bank then followed a neutral monetary policy.

In mid-August, the credit crunch forced the Fed to change course. After repeated injections of reserves into the monetary system failed to ease the liquidity crisis, the Fed cut the discount rate 50 basis points (0.5%) at an unscheduled meeting in August. Continued volatility led the central bank to reduce the Fed Funds rate by 50 basis points (0.5%) at its next regularly scheduled meeting in September. But even these moves haven't had the immediate impact desired. This can be seen by examining the relationship between the yields on 30-day commercial paper and 30-day U.S. Treasury Bills.

Is the credit crunch over?

Under normal circumstances, top-rated U.S. companies need to offer investors 25 to 30 basis points (0.25% to 0.30%) more than the yield on 30-day U.S. Treasury bills to persuade them to loan short-term capital. At the worst of the credit crisis, this spread measured as much as 3% as: 1) investors shunned anything but the safest investments, thereby driving down yields on U.S. Treasury bills; and 2) the perceptions of contagion from the asset-backed commercial

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One shouldn't consider the liquidity crisis fully resolved until the normal relationship between short-term instruments is restored and capital again becomes readily available.

U.S. Treasuries were the best performing bonds in the third quarter

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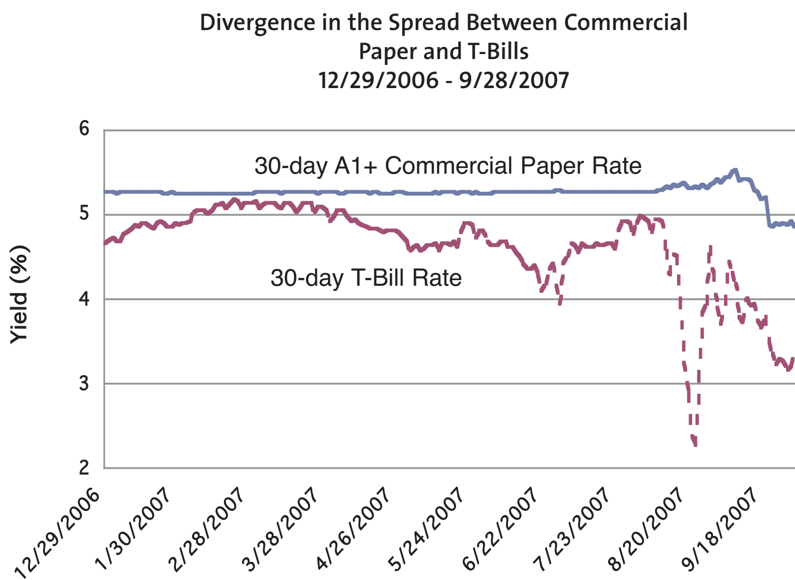
paper market to the more traditional commercial paper market essentially dried up this crucial source of many major companies' daily liquidity. As the chart below indicates, the yield spread between these two short-term investments, although improved, is still about 1.5% larger than normal. One shouldn't consider the liquidity crisis fully resolved until the normal relationship between these two short-term instruments is restored and capital again becomes readily available.

Divergence in the Spread Between Commercial Paper and T-Bills 12/29/2006 - 9/28/2007



Source: Bloomberg

The slowdown in U.S. growth increases the likelihood that the Fed will follow up its September rate cut with another later in 2007. We believe investors should continue to expect a steepening of the yield curve and increased volatility in spreads in the corporate bond market.

Foreign Exchange

All of the world's major currencies advanced versus the dollar for the third quarter, led by the Canadian dollar, which gained 7.4% to trade on a par with the greenback for the first time in history. Behind the Canadian dollar were the Japanese yen (up 7.3%), the euro (up 5.4%) and the British pound (up 1.9%). These currency movements were primarily attributable to growth and interest rates differentials that favored other countries relative to the U.S.

The dollar's weakness continues a trend that has been pretty consistent over the past five years. Since September 30, 2002, all of the major world currencies have advanced versus the dollar as high yielding markets have been perceived as superior draws for global capital. The Canadian dollar, the best performing currency, actually appreciated 59.9% versus the greenback over this period. Canada has benefited from strong global demand for its resources and steady GDP growth.

Looking forward, we are likely to see structural strengthening of the Asian currencies. China has allowed its currency, the Remnimbi, to appreciate more than 10% since changing currency policies in July 2005. This has generally been supportive of other currencies in the region. We expect a continuation of this story in the year ahead.

U.S. stocks rose as Fed intervention helped restore confidence

Domestic equity performance in the third quarter resembled an exaggerated version of the first quarter of 2007.

In both cases, stocks started off to the upside, only to have performance derailed with a mid-quarter spate of bad news and a corresponding spike in volatility. Similarly, in both cases, volatility subsided in the quarter's final month, with a resultant rise in the general market. While U.S. stocks in aggregate generally finished up for the third quarter of 2007, various market indices showed quite a range of performance outcomes. The S&P 500 rose 2.0%, the Dow Jones Industrial Average climbed 4.2%, the NASDAQ 100 jumped 8.2%, and the S&P 600/ Citigroup Small Value index actually fell -4.7%.

Credit crunch felt most by smaller cap stocks

Just as we saw in the first quarter, subprime mortgage defaults provided the bulk of the bad news that frightened investors. These defaults and the related continued weakness in the housing market led to a general credit tightening by banks, which in turn put additional downward pressure on stock prices. The credit crunch was felt most by smaller cap stocks, as these companies often have the hardest time getting loans when credit is tight. Conversely, technology stocks like those found in the NASDAQ 100 generally have little or no debt, and are therefore typically less affected by changing lending standards.

The Fed, realizing that banks' tightening credit standards had the potential to choke off economic growth, lowered the Federal Funds rate in mid-September. This easing of credit sparked a market rally through the end of the third quarter that has continued into the early days of the fourth quarter. With the Fed reassuring investors, market volatility has subsided.

Classic buying opportunity?

The bad subprime loan news at the end of July and the volatility spike at the beginning of August have thus far provided a classic buying opportunity. The S&P 500, though up only 2% for the third quarter, has also risen close to 11% from August 15th through October 5th. Looking ahead, the various surveys of investor sentiment are currently neutral to somewhat negative. This typically means that there is still some buying power on the market sidelines. That buying power may be convinced to enter the market later in the year if the U.S. economy remains on the slow growth path that we currently expect.

International stocks shrugged off the effects of the credit crunch

The third quarter was a volatile one for the global equity markets, as continued strength overseas was tempered by risks emanating from the U.S. housing market.

International stocks, as measured by the MSCI All-Country World Ex-U.S. index (net dividends), declined more than -13% from mid-July through mid-August before realizing a strong 4.7% return for the quarter. Emerging markets dominated returns for the three months, rewarding U.S. investors with a 13.7% gain, according to the MSCI Emerging Markets index. Among the emerging markets, Asia led the way, with China and India the brightest stars. The developed markets, as measured by the MSCI EAFE index (net dividends), returned just 2.2%.

Country differences sill important

For investors seeking to exploit the return differences among countries globally, we believe the terrain continues to look rich. Although the world's equity markets have become more correlated, is it really true, as nineteenth-century Austrian statesman Prince Meternich claimed, that "when Paris sneezes, Europe catches cold?" Over the short term it is undeniable. As the U.S. subprime mortgage crisis began to be felt overseas in mid-July, both the French and the German stock markets declined -6% to -7%, according to their respective MSCI country indices. But over a longer period, the first nine months of 2007, the divergence within the core of Europe was dramatic: Germany gained 26.1% while France managed just 10.4%.

For investors seeking to exploit the return differences among countries globally, we believe the terrain continues to look rich.

Digging deeper, a look at a single sector across the two European markets reveals similar performance differences. For the twelve months ended October 3, 2007, the ten largest building materials companies in Germany returned an average of 47%, while those in France advanced just 20%. These companies are global in nature, both in terms of their suppliers and customers. Nevertheless, investors have treated them very differently, in part because real GDP growth in Germany was twice that of France in 2006. Such disparate economic performance between two European Union nations sharing a common currency and monetary policy highlights the impact that even subtle differences in economic policy can have upon a country's stock market performance. It will be interesting to see whether Nicholas Sarkozy's proposed economic reforms can help France make up loss ground.

Behavioral theory suggests that, in periods of relatively low volatility, investors tend to focus more on the long-term perspective and to wait for confirming evidence to change their investment posture. Our historic analysis has shown that, in this sort of environment, momentum strategies have tended to dominate value-based ones. Although the events of the past quarter have undoubtedly increased volatility, longer term, international stock volatility remains relatively low. Viewed through this lens, we believe the recent success of markets such as Singapore, China, India and Finland is more likely than not to continue.

Positive outlook

In general, we believe the global economic outlook is remarkably good. Earnings growth around the world continues to support stock valuations. Four years into the current bull market, the price-earnings ratios in most international stock markets still offer compelling value. The global impact of the U.S. credit crisis is yet to be determined. As international finance companies report their third quarter earnings, we should get further hints of the breadth of the damage. Since U.S. economic growth is likely to be subdued, markets that depend on America's insatiable appetite for imports may fare worse than others on a relative basis. Countries that are growing due to strong domestic or regional demand are more likely to weather this period better. Here again, the prospects for India, Indonesia and China look bright.

Concerns about a repeat of the early 1990s' real estate credit crisis are probably misplaced

During the third quarter, credit quality problems in the subprime mortgage market generated similar concerns about credit quality in the commercial mortgage-backed securities (CMBS) and collateralized debt obligation (CDO) markets.

As a result, we have seen a complete freeze in the issuance of commercial real estate loans via the public securities mechanisms. Since these loan sources had come to dominate a market once dominated by private lenders such as banks and insurance companies, many equity investors in real estate are wondering if the commercial real estate market is about to suffer another credit crunch crisis such as the one experienced in the early 1990's. While the current lack of buying or selling in the investment property market gives us few data points from which to draw any conclusions, we believe that the ultimate effect of the recent credit crunch on real estate pricing will be a moderate rise in capitalization rates (cap rates), not a dramatic one. Let's examine the major issues.

Current conditions are different than the 1990 credit crunch

The 1990 credit crunch and price decline in real estate occurred in entirely different circumstances from today. Prior to the first credit crunch, the inflation of the 1980s had generated a serious overbuilding boom. As a result, vacancies rose and rents fell. The low cap rates at the time were entirely unjustified. With long-term interest rates over 8% and no immediate prospect of rising rents, cap rates had to rise to the 9% to 11% levels we saw in the early 1990's. Today, there is not overbuilding, rents are rising for most property types in most major cities, and long-term interest rates are under 5%. In this environment, barring a substantial recession, we believe cap rates of 6% to 7% are entirely justified.

Sub 5% cap rates will probably not return soon

What we probably will not see any time soon is a resumption of the sub-5% cap rates that existed earlier this year, highlighted by the portfolio sales by Blackstone in its takeover of Equity Office Properties. This private equity buyout was financed in the CDO market at roughly an 87% loan to value ratio. In today's environment, such easy debt financing is not available, and traditional long-term equity investors will probably not find themselves outbid by highly leveraged deal "flippers." Portfolio managers who had aggressively marked their real estate assets to market based on those transactions should eventually have to adjust their appraisals downward.

With many institutional investors still sitting on equity money that wants to own property, we believe there will be plenty of appetite for transactions priced to yield 6% to 7%. It is quite unlikely that anyone will see 9% cap deals, though. At a 6% to 7% cap rate, real estate should have the potential to outperform fixed income alternatives, and long-term total return expectations should be similar to those in other equity markets, such as stocks. What is unknown, however, is how long it will take for the dust to settle and more normal market activity to resume. How long will it take for potential sellers to have the confidence to put their properties back on the market, and how long it will take for potential buyers to begin actively bidding for such properties? Only when transactions begin occurring will we really know what property prices actually are.

Barring a serious recession, we believe cap rates of 6% to 7% are entirely justified.

We still recommend overweighting U.S. and international stocks

Despite extreme volatility in the third quarter, many financial markets were still able to post positive returns. The S&P 500 provided a total return of 2.0%, NASDAQ was up 3.8%, the MSCI Europe Australia Far East (EAFE) index (U.S. $, net dividends) was up 2.2%, and the Lehman Aggregate Bond index was up 3.0%. If you had been on vacation for the last three months, you would have thought it was a pretty unexciting, but profitable quarter. Other than riding through the turbulence, we made no asset allocation strategy changes during the quarter and remain overweight global equities.

We continue to have an optimistic bias toward the economy and the financial markets.

Global Bonds: Underweight

Investment grade bonds, led by U.S. Treasury bonds, turned in a pretty good quarter as investors moved toward safer assets. The ten-year Treasury bond yield fell from above 5% to about 4.5% during the quarter. We continue to view bonds' yields and relative return potential as unattractive. Outside of a recession, we believe the scope for significantly lower bond yields is limited. However, given our expectations for a slower growth environment, the risk of higher bond yields is also limited.

U.S. Stocks: Overweight

Despite increased volatility, we remain overweight U.S. stocks and continue to view dips as buying opportunities. As long as stocks remain attractively valued, earnings continue to provide positive surprises, the Fed has an easing bias and the long-term trend of the market is up, we will give the bulls the benefit of the doubt. We continue to monitor such market risks as growing tensions with Iran, election uncertainty, the increased possibility of fiscal policy mistakes and further setbacks in the housing area. Given the size and resiliency of the U.S. economy, we believe the stock market should be able to absorb most of these shocks with only short-term turbulence. In our opinion, the greatest risk to investor portfolios is an overreaction to temporary events.

International Stocks: Overweight

As with U.S. stocks, we see international stocks as attractively valued, with many emerging countries offering even better potential for economic and earnings growth. Those countries whose monetary policy is tied to the U.S. should benefit from a more accommodative Fed. The long-term trends in the international stock markets are also higher and, despite the higher short-term volatility, these trends have been very persistent. International stocks have also benefited from a weaker dollar, which has helped them outperform. We believe favorable valuations, strong earning growth prospects, accommodative monetary policy, higher market trends and a weak dollar make international stocks very attractive for U.S. investors

Real Estate: Neutral*

The commercial real estate market has been a bit softer as slower growth and a drying up in liquidity during the financial crisis caused the market to go somewhat dormant. However, real estate is a long-term investment that should not be managed on a quarter to quarter basis. Outside of a recession, we do not see a lot of downside risk for this asset class. Capitalization rates remain reasonable in the current interest rate environment and active management provides the opportunity to add value at the property level. In addition, the long-term nature of real estate offers portfolios potentially important risk-reducing diversification benefits during periods of financial market volatility.

Alternative Investments: Neutral*

The recent financial market turmoil reinforces our belief in using alternative assets to offset the risk inherent in equity only portfolios. While some of these strategies are designed to specifically reduce short-term volatility, others seek to take advantage of long-term themes which are less susceptible to short-term disturbances.

*Real estate and alternative investments are not suitable for all investors.

U.S. INTEREST RATES	12/31/2006	3/31/2007	6/30/2007	9/28/2007
Cash Equivalents				
90-Day Treasury Bills	5.02%	5.04%	4.81%	3.81%
Federal Funds Target	5.25%	5.25%	5.25%	4.75%
Bank Prime Rate	8.25%	8.25%	8.25%	7.75%
Money Market Funds	5.11%	5.10%	5.14%	5.06%
Bonds				
30-Year U.S. Treasury	4.81%	4.85%	5.13%	4.84%
20-Year AA Municipal	4.04%	4.05%	4.40%	4.28%

Sources: Datastream International and Bloomberg L.P.

GLOBAL BOND MARKET TOTAL RETURNS (US$) THROUGH 9/28/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Bonds			
Merrill Lynch 7-10 year Treasury Index	4.70%	5.01%	5.60%
Merrill Lynch 7-10 year Agency Index	4.31%	4.58%	5.82%
Merrill Lynch 5-10 year Corporate Index	1.65%	2.36%	3.79%
Lehman Bros. Municipal Bond Index	1.83%	1.97%	3.10%
International Bonds			
Citigroup non-U.S.$ World Government Bond Index, fully hedged	2.90%	2.88%	3.57%

Sources: Bloomberg L.P. and S&P Micropal

GLOBAL STOCK MARKET TOTAL RETURNS (US$) THROUGH 9/28/2007	QUARTER	YEAR TO DATE	ONE YEAR
U.S. Stocks			
Dow Jones Industrial Average	4.19%	13.31%	21.67%
S&P 500	2.03%	9.13%	16.43%
NASDAQ 100	8.23%	19.43%	27.02%
S&P SmallCap 600/Citigroup Value	-4.69%	1.81%	10.36%
International Stocks			
MSCI Japan, net dividends	-0.86%	1.96%	7.07%
MSCI Europe (includes UK), net dividends	1.69%	14.39%	27.51%
MSCI EAFE (Europe, Australia, Far East), net dividends	2.18%	13.15%	24.86%

Sources: Bloomberg L.P. and S&P Micropal

REAL ESTATE TOTAL RETURNS (US$) THROUGH 9/28/2007	QUARTER	YEAR TO DATE	ONE YEAR
NCREIF National Property Index*	4.59%	13.35%	18.46%

Source: The National Council of Real Estate Investment Fiduciaries

*Return for latest quarter is an estimate.

Past performance is no indication of future results.

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About *the 9:05*

Since 1978, we've held a weekly companywide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as the 9:05.

Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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