Market Review

If one were to look at the starting and ending point for markets last quarter, you would describe performance in-line with historical averages. The broad market as measured by the Russell 3000 increased 1.1%, while the technology heavy NASDAQ index and the well known Dow Jones Industrial index topped all headline indices, returning 3.8 and 3.6%, respectively. The path traveled to get to those points was quite volatile with the Russell 3000 index fluctuating between 6.9% down and 3.3% up for a peak to trough move of more than 10%.

As in the past, markets moved up and down as fears about the state of the economy ebbed and flowed. Central to the outlook was the uncertainty of the effect of the credit market turmoil on the total economy. We expand on what happened and give our opinions on the long-term effect on markets in more detail in the adjacent special section of this letter called "Deconstructing the Credit Bubble".

In our outlook last quarter, we forecast that surprising strength of company earnings reports for the second quarter would drive stock returns in the third quarter. We were correct that earnings would surprise to the upside. According to Reuters, the bottom up analyst expectations for earnings growth was 5.8% while companies reported 9.6%. What we did not expect was the overwhelming effect that the credit market turmoil would have on overall market action. In the end we maintain that while some market dynamics have changed (debt is more expensive), company fundamentals, and earnings strength in particular, resulted in the positive returns for the quarter.

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More detail analysis of market performance reveals the following statistics:

1) Large companies (as measured by the Russell 1000 index) outperformed smaller companies (as measured by the Russell 2000 index) +1.5% versus -3.4% continuing the outperformance that started in the second quarter of 2007.

2) Growth (+3.6%) outperformed value (-1.4%) for the third quarter in a row.

3) Domestic stocks as measured by the Russell 3000 again underperformed International stocks (non-U.S. stocks measured by the MSCI AC ex U.S. index) (+1.1% vs. +2.2%). The only time that domestic stocks outperformed international stocks in the last two years was the third quarter of 2006.

4) Energy (+8.4%), Industrials (+5.2%), IT (+5.0%) and Materials (+4.0%) sectors were the principal sector contributors to index gains last quarter.

5) Financials (-5.1%) and Consumer Discretionary (-6.4%) were the only two sectors that declined last quarter. ■

Deconstrucing the Credit Bubble

Like most speculative bubbles, the current credit crisis has proceeded through five stages: A novel offering, aided by the expansion of credit, leads to increased speculation and, ultimately, financial distress as investors begin to flee, leading to panic selling.

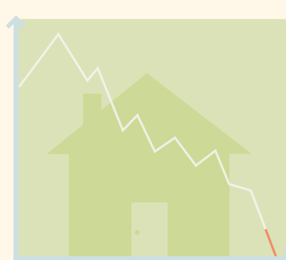
> **"I can calculate the motions of the heavenly bodies but not the madness of people."**
>
> *– Sir Isaac Newton, 1721*

This famous quote was taken shortly after Sir Isaac Newton had lost a considerable amount of money in the infamous "South Sea Bubble"[2]. As the date of the quote illustrates, speculative bubbles are nothing new, and while the object of fascination may change, the underlying human psychology and behavioral patterns are quite consistent across time. Thirty years ago, an economist named Charles Kindelberger captured these behavioral patterns in a book entitled, "Manias, Panics and Crashes". Since that time, the five stages of financial manias outlined in his book have become the standard by which to analyze and deconstruct speculative bubbles. We felt a review of the housing meltdown and resulting credit crisis using this framework would be timely as well as useful in putting the current credit crisis in context.

Novel Offering

According to Kindelberger, the initial stage of a bubble is usually defined by a novel offering (i.e., new market, revolutionary technology, innovative product) underwritten by eager investors in search of higher returns.

In terms of the recent credit crisis, the novel offering was the **securitization of mortgage loans**, which served to funnel liquidity from providers of capital (investors) to users of that capital (individual mortgage holders). While the securitizing of loans was certainly not a new concept, a prolonged period of low interest



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[2]*In 1711, the British government granted the South Sea Co. a monopoly on trade with South America and the Pacific islands. The resulting explosion in the stock price and subsequent panic-induced sell off in 1720 is often used as a synonym for financial manias or speculative bubbles.*

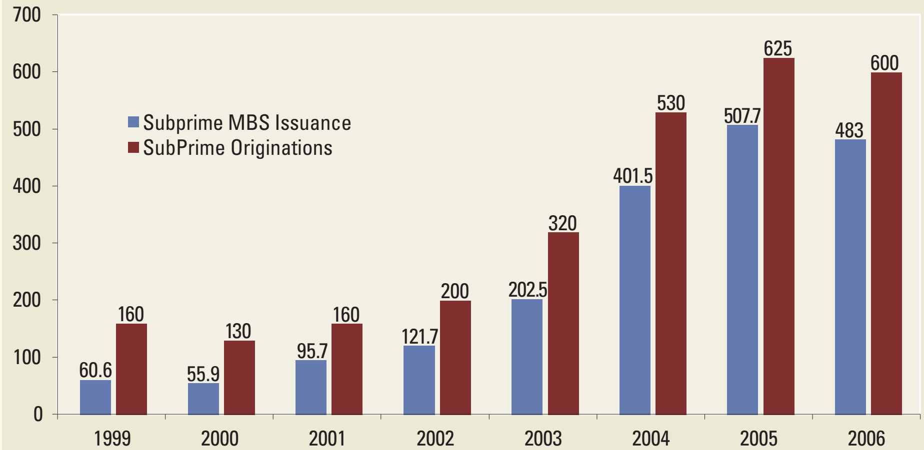
Credit Bubble (continued from 2)

rates created a need (market) for higher yielding securities.

Bankers responded by pooling individual mortgage loans together and using the income generated by these loans as collateral to create Residential Mortgage Backed Securities (MBS). These prepackaged loan securities were made up of "tranches", or groupings of mortgages with similar risk profiles. In theory, this offered the best of both worlds: higher yield with less risk, as the conventional wisdom held that spreading risk among a large group of investors would lower the overall risk to each individual investor.

Exhibit 2

Growth in Subprime Mortgages



Sources: *Inside B&C Lending, Inside Mortgage Finance*

Credit Expansion

Once a novel offering captures the public's imagination, it enters a second stage, characterized by the availability of credit to meet the increased demand for the offering.

Historically low interest rates, coupled with double digit increases in home prices, served to increase the availability of credit to all borrowers, regardless of credit history. Burdened by increasing pressure to put excess liquidity to work, bank credit standards deteriorated to the point where lenders were using questionable tactics to approve loans that in many cases amounted to 100% of the appraised value of the home.

Exacerbating the situation were Adjustable Rate Mortgages (ARMs), which lured high risk, "subprime" borrowers into buying a home on the premise that they would be able to refinance before the low "teaser rates" on the mortgage reset in two years. The underlying problem was that no one, from the borrower to the broker to the lender, had an incentive to stop. Since most of the loans were packaged and sold off to investors, lenders and brokers had every incentive to close the sale since commissions were paid only once the sale was consummated. As a result, the amount of subprime mortgages issued and imbedded in Mortgage Backed Securities shot up from $56 billion in 2000 to $508 billion at the peak in 2005 (see Exhibit 2).

Speculation/Mania

In this stage, investors scramble to get in on the latest craze, not wanting to be left out. Emblematic of this stage is the formation of new investment pools, a flood of new issues into the marketplace and a move from cash (seen as unattractive) to relatively illiquid securities with higher yields.

In the quest to satiate investor's appetites for higher yields, bankers further repackaged the hard-to-sell, mid level risk tranches (mortgages rated A to BB) from each MBS into a new security called a mezzanine collateralized debt obligation (CDO). Credit rating agencies assumed that any expected losses stemming from individual subprime mortgages imbedded in these securities would be muted by the geographical dispersion of the underlying loans (i.e., real estate prices in the Southwest would be unaffected by price swings in the Northeast). As a result, these mezzanine CDO's were given investment grade ratings[3] by the credit rating agencies, unleashing a tidal wave of demand from banks, hedge funds, and institutional investors in the U.S. and abroad for these higher yielding, "investment grade" securities. Banks, in particular, set up off balance sheet conduits known as structured investment vehicles (SIVs) to hold these CDOs. In addition to providing these banks with a way to invest in slightly higher risk securities, these SIVs enabled banks to tap the asset-backed commercial paper market for short term funds. In effect, they were borrowing in short term liquid form to invest in longer term illiquid (higher yielding) securities.

Distress

This stage is usually triggered by an exogenous event, marking a turning point in market direction.

In terms of the credit crisis, that exogenous event came in the form of a slowdown in the housing market in hot subprime areas like California, Arizona and Florida, coupled with an increase in interest rates. All of a sudden, borrowers banking on double digit increases in housing prices and low interest rates to refinance or sell their home before their ARMs reset, were stuck with mortgage payments resetting to levels substantially higher than they had originally estimated.

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[3] *According to Barron's, 80% of the MBS BBB tranches included in repackaged CDOs were given a AAA rating. Baron's article, "Garbage In, Carnage Out", Jonathon Laing, July 9, 2007.*

Credit Bubble (continued from 3)

As defaults and foreclosures increased in the subprime segment of the mortgage market, investors began to worry that weakness in the sector would spread to other sectors of the mortgage market and to the overall economy.

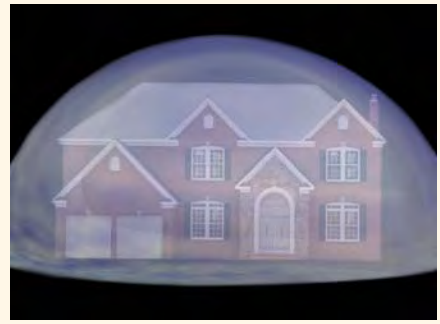
Crash & Panic

The final stage is a bursting of the bubble, characterized by investors unloading their investments at greater and greater losses. In a "flight to quality", cash once again becomes king.

The first sign that the subprime meltdown would have ramifications far beyond main street was made apparent when two Bear Stearns hedge funds, holding nearly $10 billion in mortgage-related securities, imploded – one wiped out completely, the other lost 90% of its value. The inability of these hedge funds to value their illiquid portfolio holdings unnerved investors both here and abroad, forcing many Asian and European banks to come clean about the extent of their U.S. subprime exposure. Most banks did not have a handle on what they owned, assumed all other banks were in a similar position and were therefore unwilling to lend to other banks. To make matters worse, the credit crunch soon spread to the commercial paper market, cutting off a critical source of funding for bank SIVs. While some banks were able to cover these funding requirements, others were forced to sell the securities, increasing the likelihood of further CDO losses elsewhere. The confluence of these events helped push the "TED Spread", a commonly used indicator of credit risk, to 250 bps, the highest level in 20 years (see chart).

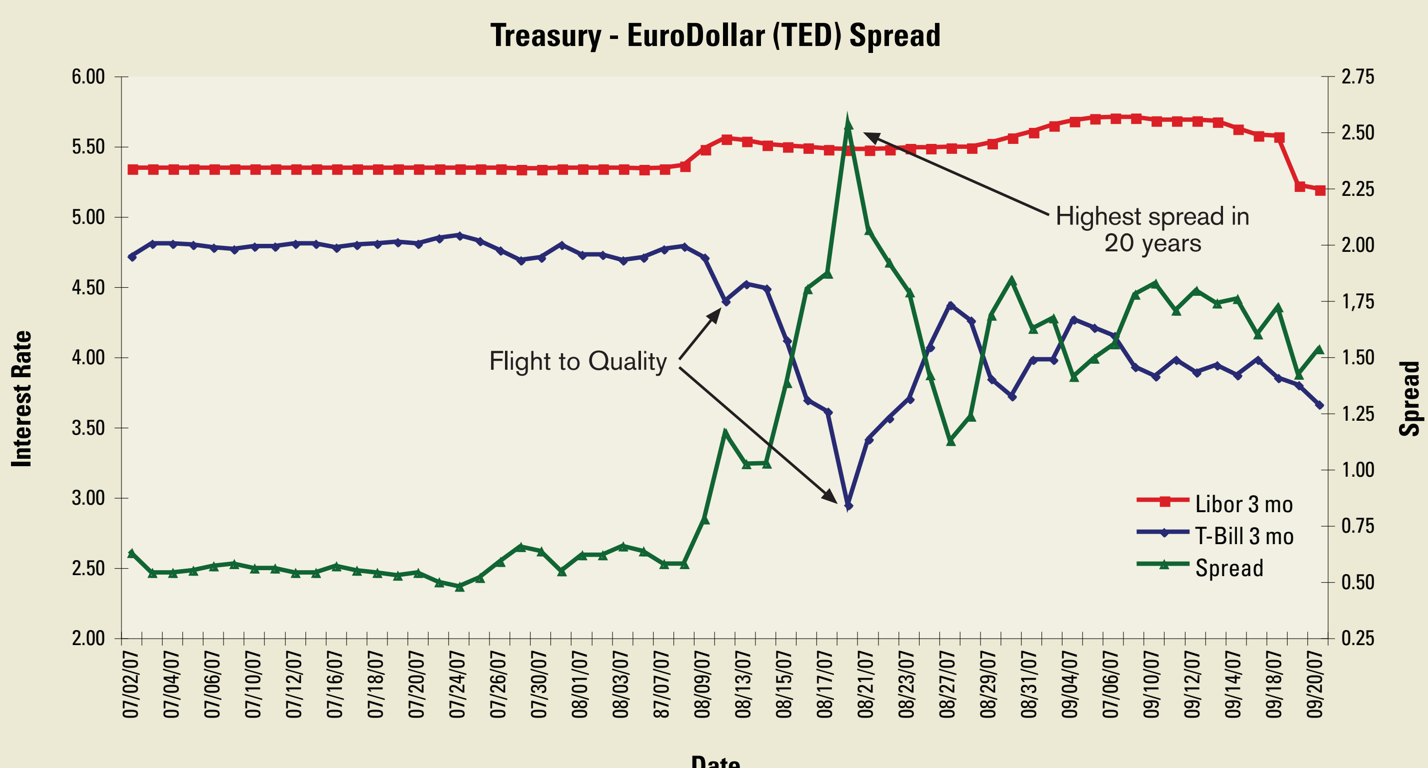
Conclusion

The duration and severity of the current credit crisis will ultimately be determined by how the credit derivatives described above are unwound. While central bankers in the U.S. and Europe have shown a willingness to step in to stabilize markets (and bail out investors), their short-term actions could have longer-term implications in helping set the stage for the next speculative bubble, whatever that novel offering may be. ■



In terms of the credit crisis, that exogenous event came in the form of a slowdown in the housing market in hot subprime areas like California, Arizona and Florida, as well as an increase in interest rates.

The Ted Spread, or the difference between the interest rate for U.S. Treasuries and EuroDollars, is a commonly used indicator of credit risk. This is because U.S. T-bills are considered risk free while the rate associated with the Eurodollar is thought to reflect the credit risk of corporate borrowers. As the TED spread increases, default risk is considered to be increasing, and investors will have a preference for safe investments. As the spread decreases, the risk of default is considered to be decreasing.



Sources: BBALibor.com; YahooFinance.com