Red Granite Advisors LLC
First Quarter 2008 Commentary

Stock prices slumped in the first quarter as housing woes, recession fears, credit market seizure and the collapse of investment bank Bear Stearns strained investor confidence. Paced by significant weakness in the financial and consumer sectors, the Russell 1000 Growth Index tumbled (10.18)% and the S&P 500 returned (9.44)%. Relative to these figures and consistent with our record of protecting principal in falling markets, Red Granite's Large Cap Growth portfolios meaningfully out-performed, posting more modest declines. Client accounts were underexposed to the weakest sectors, while being overweight in energy, and having material cash reserves, all benefiting relative performance.

Odds are high that the US economy is already in recession. Home prices are falling, energy and food prices rising, debt levels burdensome and income growth minimal. Although tax refunds and rebates totaling $152 billion will provide some relief to consumers, absent the benefit of mortgage equity withdrawal, sustained consumer spending will depend on income gains. Home prices must also stabilize to staunch the negative wealth trends weighing on confidence.

Economic concerns and market distress prompted Federal tax rebates, liquidity injections by some foreign central banks, and unprecedented action by the Federal Reserve. Both the federal funds and discount rates have been cut by more than 3% since the subprime crisis emerged last year. The Fed also established over $400 billion in new credit facilities to improve market liquidity and, under authority granted during the Great Depression, made its credit facilities available to non-bank, financial institutions. Designed to bolster market liquidity, reinvigorate credit creation and spur growth, these stimuli are powerful; but at this point, creditors remain reluctant to lend, loan securitization has ground to a halt, and yield spreads remain elevated.

An accommodative Fed and a weak dollar increase the odds of an improved US economy, but also sow the seeds for a secular (i.e., long-term) increase in inflation by keeping commodity and import prices high. In the post-war period, the US has progressively borrowed more in each decade to produce an equivalent amount of GDP growth. As has been true in most post-war business cycles, the most painless way out of America's over-indebtedness is to pay-off debt with "cheaper" (inflated) dollars. Though painful for many, the processes of deleveraging and recapitalizing the financial sector will result in new regulations and likely cause the ensuing recovery to be tepid and prone to inflation. Consequently, once bond investors' flight-to-safety in US Treasury securities subsides, higher inflation risks should be reflected in higher long-term interest rates.

At this juncture, stock prices appear vulnerable on two fronts: Price-to-earnings ratios could erode as investors anticipate higher long-term interest rates and a secular rise in inflation; and, profit expectations could fall as the US economy slows. Although difficult to gauge, the profit decline could be significant, especially if the contraction is prolonged or spreads globally.

Good buying opportunities will eventually emerge amidst disconcerting economic forecasts and mounting financial losses. The tightening of yield spreads and moves from reluctant European bankers to reduce interest rates will likely presage the return of investor confidence. Our focus on established companies with innovative managements able to adapt quickly to changing market dynamics and those with the strongest balance sheets should be rewarding. Characterized by above-average cash reserves, our current strategy provides us flexibility to selectively add to investments as valuations become more attractive.

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