

# Fourth Quarter 2007 Commentary

Stock market volatility surged last quarter as investors grappled with ongoing fallout from the mortgage market meltdown and growing US recession risks. After posting all-time highs in early October, stock prices dropped ten percent to their November lows before grinding out a partial recovery by year end. For the quarter, the Russell 1000 Growth Index gave back -0.77% while the Standard & Poor's 500 Index fell -3.33%, taking full year total returns for these benchmarks to +11.82% and +5.49%, respectively.

The opacity of Wall Street's newer investment products, an alphabet soup of complex structures such as residential mortgage-backed securities (RMBS), credit default swaps (CDS) and collateralized debt obligations (CDO), along with massive write-downs by major financial institutions, eroded confidence among capital market participants. Compounding the problem was that much of the "financial alchemy" and lending activity occurred outside of the traditional banking system and emphasized leverage over safety. As loss estimates for major banks and brokers escalated, investors reacted negatively to the widening range of potential economic outcomes.

Red Granite Large Cap Growth Equity Composite returns trailed the Russell 1000 Growth Index in the quarter; they were modestly better than the S&P 500. The primary drags on performance were small stock positions in the retail industry and mixed results in the health care and consumer staples sectors. Supporting the double digit returns for the year were large gains in energy stocks, along with advances in selected financial, industrial and health care issues. Relative to the Russell Index, the year's performance shortfall largely came about in the final quarter; however, as this Commentary is being written a good part of the under-performance has been recovered in January. Financials proved to be a major drag on the S&P 500 last year, but our picks were slightly accretive in client accounts.

Up to now, consumer spending has been remarkably resilient despite big jumps in food and energy prices, rising health care costs and sluggish wage gains. This resiliency was made possible by a significant increase in consumer debt burdens and a decrease in saving rates over the years. Now, as the housing recession depresses home prices, lenders tighten mortgage standards, and employment growth stalls, the ability of US consumers to support spending with still more debt is severely limited. With consumer spending accounting for more than two-thirds of US gross domestic product (GDP), it is unlikely that strength in other sectors of the economy, such as exports and government, will be enough to offset a potential retrenchment by consumers. Consequently, the risk is rising that the US economy slips into recession, an event likely to have a significant impact on global economic growth.

# Fourth Quarter 2007 Commentary ~ Continued

As the slowdown in the US becomes more apparent and recession odds rise, the Federal Reserve will likely act more aggressively to stem a decline by lowering short-term interest rates further. In addition, foreign central banks are likely to follow the Fed's lead as their economies feel the impact of weaker US consumer spending. Since this slowdown will likely be consumer led, it is logical that targeted fiscal measures to boost spending would be effective. If, in the next few months, the Democratic Congress and the Bush Administration can pass a significant package of relief measures aimed at the most vulnerable segments of our economy, a recession may be avoided. Another key to a more favorable outcome is the potential for a meaningful decline in energy prices (e.g., a decline to \$70-\$80/barrel oil). Such a decline would act like a tax cut for consumers, freeing-up income to be saved or spent in ways that benefit the broader US economy.

Lower prices for energy, and other commodities sensitive to a slowdown in global economic growth, should ease inflation fears. Also, the absence of wage pressures in most developed economies reduces the inflation threat. As a result, the Federal Reserve and other central banks may not be constrained by inflation worries in their application of monetary stimulus measures. Nevertheless, any easing in inflation pressures is likely to be temporary. The eventual recovery in global economic demand for basic commodities and the flood of liquidity necessarily unleashed by central banks will keep the secular trend of inflation "creep" intact. Consequently, although inflation is likely to be well-behaved over the near-term, it remains a long-term risk.

Stock prices appear potentially vulnerable on two fronts. First, valuations (i.e., price-to-earnings multiples) could erode as investors anticipate higher long-term interest rates and a secular rise in inflation. Moreover, wide credit market spreads reflect investors' risk-averse attitudes; consequently, equity risk premiums are rising. Second, profit expectations could decline significantly due to the US economic slowdown. Although difficult to gauge, the profit decline could be severe, especially if the economic slowdown is prolonged or spreads globally. Until we see stabilization in the credit markets, i.e. narrowing spreads, stock valuations will remain under pressure.

Our equity investments emphasize high-quality companies with financial staying power and meaningful exposure to faster growing foreign economies. We also seek companies that provide attractive cash returns to shareholders through rising dividends and/or share buybacks. Finally, we look for stocks that provide a valuation margin of safety. We are careful not to overpay for a company's earnings prospects and will trim a position if we believe a stock's valuation is extended. Our current strategy is characterized by over-weighted positions in energy and health care companies, less-than-market exposure to financials and discretionary consumer spending, and above-average cash reserves. The last gives us the flexibility to make selective additions to stock investments as valuations become more attractive.