Second Quarter 2007 Commentary

Stock prices moved sharply higher in the April-May period as signs of an improved US economy and better-than-expected corporate earnings bolstered investor confidence. Share prices retreated in June as rising interest rates and fears of additional fallout from the subprime mortgage meltdown prompted profit taking. For the June quarter, the Standard & Poor's 500 Index gained 6.27% while the Russell 1000 Growth Index jumped 6.86%, taking year-to-date returns for these benchmarks to +6.96% and +8.13%, respectively.

While client portfolio returns were solidly positive, they trailed the indices. In a sign of investors' aggressiveness, weaker stocks were in more conservative sectors – consumer staples and health care; providing the lift to performance was the portfolio's exposure to more economically-sensitive groups such as energy, technology and industrials.

Turning to the outlook, though the US economy faces headwinds from the housing recession and higher energy prices, the global economy continues to grow impressively. With the notable exception of Japan, growth outside the US has been better than expected. The good news is that along with a weak US dollar, robust foreign economic growth generates rising demand for US exports, especially capital goods, providing an offset to softness in the US consumer sector. The downside to more robust global growth is that it keeps upward pressure on interest rates and global commodities such as oil, industrial materials and foodstuffs. As a result, the odds are now higher for an extended period of subdued US economic growth. At the same time, continued employment gains and the absence of spillover from the housing recession to other parts of the US economy limit the odds of an outright decline in US economic activity. Consequently, the "soft landing" scenario, where the US economy slows just enough to create slack in the labor and raw materials markets in order to contain inflation without slipping into recession, remains the most likely outcome.

Robust growth outside the US increases the probability that economic growth in the US will reaccelerate once the housing market begins to recover. However, the timing of a turn in housing is difficult to predict. The peak period of adjustable rate mortgage resets, when mortgage payments could rise substantially for some homeowners, still lies ahead. Bank of America estimates these upward resets could amount to $500 billion this year and $700 billion in 2008. In the meantime, losses on low quality credit instruments (e.g., Collateralized Debt Obligations that invested heavily in subprime mortgages) are accelerating while legislative and regulatory reactions could make matters worse. Still, with home prices flat for over a year and newspapers filled with subprime mortgage horror stories, we believe the worst of the housing recession could be over by next spring.

Second Quarter 2007 Commentary ~ Continued

We are becoming increasingly concerned that, because of excess liquidity and the extensive use of derivatives, there exists an enormous, yet unquantifiable, amount of leverage (debt) in the capital markets. Further, many substantial participants in the financial markets e.g. hedge funds are either lightly- or un-regulated. As a result, no one can say with certainty that losses associated with an ill-conceived strategy will be absorbed without causing financial or economic contagion. Tightening credit conditions appear to be spreading beyond the mortgage market, credit spreads are widening and risk premiums will eventually rise. We may soon know the true "hits" to CDO portfolios as distressed sales of the securities force a mark-to-market pricing discipline on holders versus the "price-to-model" formulaic approach currently used to value these potentially illiquid positions.

The divergence between US and foreign economic growth rates could be viewed as evidence the era of a US-centric world economy is finally coming to an end. In other words, the rest of the world is no longer dependent on the US "locomotive" to drive growth. Global growth that is more balanced should be more sustainable. More balanced global growth is a natural outcome of the globalization process put in motion by the fall of the Berlin Wall in 1989, as countries representing two-thirds of the world's population shift from closed command-and-control economic regimes to more open market-oriented systems. Globalization enhances economic growth by opening up new markets and boosting international trade. Globalization also works to keep inflation low by expanding supply and promoting competition. However, some observers worry that globalization's "low hanging fruit" has already been picked and that a growing globalization backlash, illustrated recently by stalled free-trade initiatives, restrictions on foreign investment and other protectionist measures, could limit future growth.

The sustainability of today's global economic boom is difficult to gauge since the trends driving globalization are powerful yet subject to the political process. Our objective is to participate in what could be substantial financial market upside if the globalization process continues unabated, yet cushion the downside should global growth become untracked. Our current strategy calls for maintaining normal equity exposure in order to participate in potential market upside while managing risk through careful stock selection. 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 share buybacks. Finally, we look for stocks that provide a valuation margin of safety, that is, 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.