

# Third Quarter 2007 Commentary

Courtesy of Federal Reserve (Fed) policy action, stocks shrugged off the subprime mortgage contagion infecting credit markets to post modest gains during the September quarter. The near collapse of a handful of high profile hedge funds due to wrong-footed bets on risky mortgage-backed securities and the evaporation of liquidity in short-term sectors of the debt market caused stock prices to plunge more than ten percent from their mid-July highs to their August 16th intra-day lows. Subsequent central bank intervention to contain the fallout from the subprime meltdown reassured investors, who responded by bidding stock prices higher. For the quarter, the Standard & Poor's 500 Index gained 2.03%, and the Russell 1000 Growth Index rose 4.21% taking year-to-date returns for these benchmarks to 9.13% and 12.68%, respectively. Red Granite's high-quality, large-cap growth style significantly outperformed both indexes.

The relative strength in quarterly account performance was supported by double digit stock price gains in three sectors: consumer staples, energy and materials. Stock selection in many categories was strong, and a sizeable overweight in energy relative to the Russell Index was a major positive. Other performance influences in the quarter were the trends of growth stocks outpacing "value" and large companies dominating smaller-cap entities.

Shifting to the outlook, ongoing turmoil in the mortgage market implies that the US housing adjustment is likely to take longer and go deeper than previously expected. The supply of housing units for sale will remain elevated as homes and condos come on the market following foreclosure and homeowners unable to afford their reset adjustable-rate mortgages are forced to sell. At the same time, the demand for housing will remain depressed as tighter mortgage lending standards reduce the number of eligible buyers, and falling home prices lead buyers to delay their purchase decision in the hope of realizing a lower price.

Falling home prices and tighter lending standards could also jeopardize the sustainability of consumer spending gains as the ability to extract home equity to supplement income withers. As it stands, strength in the US export sector is offsetting weakness in the housing and related financial sectors, resulting in modest US job gains, rising incomes and slow, but positive, economic growth. As financial and economic risks increased, the Federal Reserve's policymaking Federal Open Market Committee (FOMC) lowered the Federal Funds rate (the overnight lending rate between banks) by half of a percentage point at their September 18th meeting. The FOMC also lowered the discount rate (the lending rate between the Fed and banks) by half a percentage point at the September meeting, taking the reduction in this "emergency" rate to a full percentage point since the outbreak of subprime contagion in August. These moves were echoed by the central banks of the UK and the Euro zone, injecting massive doses of liquidity into the global financial system. Recent comments by several Federal Reserve officials indicate the FOMC may react aggressively to the threat of economic weakness, pushing down short-term interest rates faster and farther than market participants currently expect. It is obvious that economic stability is their prime directive, not inflation or the dollar's value.

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An aggressive reaction function from the Federal Reserve increases the risk that inflation will eventually become a problem, and it weakens the US dollar's foreign exchange rate. A weaker dollar drives up the prices of imported goods, and challenges foreign investors who may become less inclined to hold dollar denominated securities, putting upward pressure on longer-term US interest rates and downward pressure on US bond prices. The magnitudes of these potential negative outcomes depend on the path the dollar follows to a lower exchange rate. In opting for an aggressive reaction function, the Fed is betting that inflation will be contained by the deflationary influences of globalization and that the dollar will maintain its reserve currency status.

The rapid recovery in stock prices from the "summer swoon" reflects investor confidence that the Fed's aggressive moves are evidence that they are committed to avoiding a US recession and that the worst of the subprime fallout is behind us (or at a minimum, the scope of the damage is known). If the Fed successfully engineers a "soft landing" (i.e., the US economy slows just enough to create slack in the labor and raw materials markets in order to contain inflation, yet avoids slipping into recession), equity markets may be correctly discounting improved US economic conditions.

We believe the soft landing scenario is the most likely outcome for the US economy; thus, our current strategy calls for maintaining full equity exposure in order to participate in potential stock 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. We believe that the most recent quarter's performance is testament to our view that the long standing underperformance of high-quality, large-cap growth has been reversed and that this style should outperform on a multi-year basis. Large-cap growth has traditionally outperformed late in the business cycle, as profit growth slows, and during periods of dollar weakness because of the companies' global reach.