



MARKET COMMENTARY

January 22, 2008

The financial markets have been buffeted by a number of crosscurrents since the middle of last year, with a heightened intensity thus far in 2008. Included among the issues that have been causing this volatility are: the slump in the domestic housing market; credit market concerns punctuated by the sub-prime loan crisis and pressure on discretionary consumer spending related to higher energy prices, as well as mortgage and credit card debt burdens. These issues and others, including the weak US dollar and fear of inflation (as related to raw material costs) and heavy reliance on foreign buying of US debt securities, have conspired to reduce expectations for economic growth in the US, in continental Europe and several Pacific Rim economies, including Japan.

This morning, the credit markets were somewhat surprised with a 75 basis point cut from the Federal Reserve. In addition, there has been talk of fiscal policy stimulation in the form of making the current temporary tax cuts permanent in order to assist consumer spending. Also being discussed is a one-time tax rebate, such as we have seen in the past, which would be intended to provide an immediate stimulus. There is also currently talk of tax breaks on housing or industrial development bonds in order to encourage business spending. The current 2-10 year Treasury yield curve stands at +143 basis points (1.43%) versus an average slope of 98 basis points (0.98%), over the last five years. This is primarily the outcome of a flight to quality and trading hedges from a nervous market. As a result, 15-year mortgages are half a point cheaper than 30 year mortgages. The refinancing and quality mortgage markets have picked up substantially in the past month. With this morning's cut in rates, there is more incentive for Americans to refinance and ease their financial burdens, even considering stricter lending practices.

I n o r d e r t o a c h i e v e r e t u r n s
i n e x c e s s o f a b e n c h m a r k , o n e m u s t
b e i n v e s t e d d u r i n g t h o s e a b e r r a n t
m o n t h s a n d q u a r t e r s .

Since hitting a bear market/post recession low in March of 2003 and through the end of last year, the equity market advance has been quite impressive but not without some interruptions along the way. For example, the market corrected 6.4% in the summer of 2004. There was a 5% correction in both 2005 and 2006 and a correction of almost 7% last summer. Since the trough in 2003, the market produced a total annualized return in excess of 14%, as measured by the S&P 500. In those 19 calendar quarters (3/31/03-12/31/07), the market produced a negative total return in 4 of those 19 quarters or 21% of the time. In three of those five calendar year periods, the market return was less than the average annualized return for the entire 19-month period. A couple of very fast takeaways is that market returns are not smooth and, in order to achieve returns in excess of a benchmark or standard, one must be invested during those aberrant months and quarters.

The housing market slump and the sub-prime loan issue have clearly had a significant impact on market psychology, as well as created concerns about a significant economic slowdown. These issues have been exacerbated by the media looking for stories other than election primaries and caucuses. We would agree that economic growth will slow in 2008, as compared to 2007, but this is not atypical of a mid-cycle slowdown within the framework of an economic expansion.

We have maintained a very strict discipline in the construction of our clients' portfolios. There have been long stretches during the last five years where abandoning this discipline for one that assumed more risk in a quest for short term returns may have been very tempting to a less disciplined investment management firm. In this environment, we will continue to adhere to our philosophy and process of identifying and utilizing well-capitalized enterprises that consistently deliver above-average financial performance and where the fundamental elements (balance sheet metrics), as well as valuation, remain attractive. Equally, we will maintain the high quality stratification and conservative durations that have become trademarks of our fixed income process.