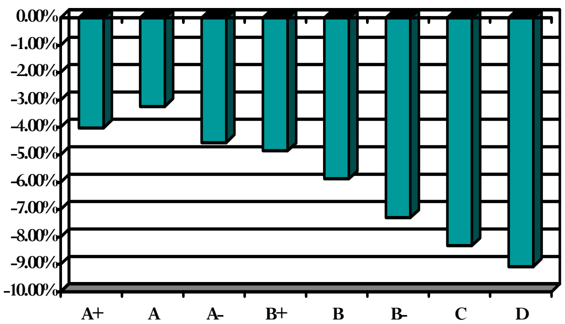
September 2007

Chain, Chain, Chain…

After a great first half, the equity market has had a roller coaster ride so far in the third quarter, and is down 1.7% through the end of August. The small net change, however, masks the increase in volatility. During this quarter, the market has seen some of the biggest up and down days it has experienced in quite a while. One change that has been evident since the selloff that began July 19 is the flight to quality, which has occurred in the equity market as well as the bond market. From the market's peak through the end of August, low quality stocks have experienced a much larger decline relative to high quality stocks.

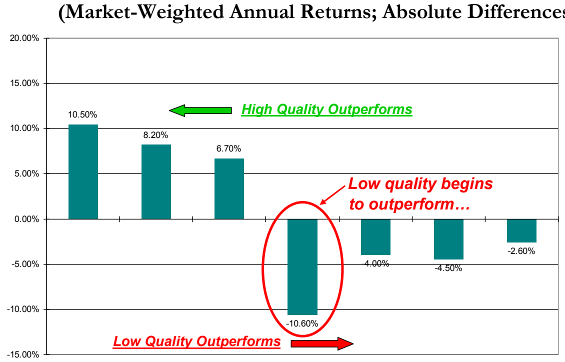
Performance by Quality Ranking 7/19/07-8/31/07
Russell 3000 Index



Source: Standard & Poors; Frank Russell

As the next chart illustrates, low quality stocks have been leading the market since 2003. However, several factors have been building in favor of high quality, including attractive relative valuations, slowing profit growth, rising market volatility, and better relative performance of larger stocks. Profit growth has been slowing in the US, with S&P profits expected to be up only 7% this year compared to 14% in 2006. The VIX, an options volatility measure used to indicate overall market volatility, has more than doubled since the beginning of the year. Historically a rise in the VIX has been positively correlated with better relative performance by higher quality stocks. Finally, large caps, which tend to be higher quality, have been performing better than small caps. Year-to-date through August, the Russell 200 is up 5.04% compared to 1.39% for the Russell 2000.

A Rated Cos. minus B,C,&D Rated Cos.
(Market-Weighted Annual Returns; Absolute Differences)



Source: Standard & Poors

Despite these factors, quality has been slow to respond. In the market selloff in May of 2006, high quality stocks held up well, but their dominance was short lived. In the selloff earlier this year, there was no real flight to quality. So what has kept high quality back?

We believe several issues have prolonged the outperformance of lower quality: (1) very high global liquidity which has persisted for some time, (2) securitization-the packaging of debt that has resulted in the explosion of new financial instruments, (3) the dramatic increase in the number of hedge funds (about 9,000 today) and private equity funds (about 2,500 today), (4) a low return environment, encouraging investors to take on more risk to increase returns, and (5) continued positive earnings surprises, despite a slowing economy. All of these things have lead to an increased appetite for risk. On the credit side, this has resulted in very low spreads; on the stock side, a bidding up of low quality, riskier stocks.

But now we are seeing some changes in the market. What started as a downturn in the housing market has resulted in a chain reaction. First, liquidity is generally drying up. While the Fed may lower rates soon, it has indicated that it does not want to bail out those market participants that made poor investment decisions. Central Banks have been slowly raising rates around the world. General credit is tightening significantly. Banks no longer want to make loans on the same easy terms that they did and homebuyers are certainly finding it more difficult to qualify for loans.

Securitization continues, but there is now more scrutiny of the loans that go into each security. The market for CLOs and CDOs, debt instruments backed by leveraged loans and subprime loans, has fallen dramatically. CLOs have been the main sources of funding for private equity firms. The value of leveraged loans waiting to be sold as of August was $231 billion, up from a record $62 billion this time last year, but now there are very few buyers.

Hedge funds have been buyers of these lower quality instruments and used considerable leverage to do so. Now as they retrench and deleverage, this will put further pressure on these types of securities, making them more difficult to sell. Thus it will be much more difficult for private equity firms to make the kinds of deals that they have been making. Some of the underperformance of lower quality stocks over the last few weeks reflects the removal of this potential takeout premium.

Finally, it will be harder for the consumer and the financials to hold up the economy, putting downward pressure on earnings in general.

A Fed rate cut will help, but we will not return to the easy money environment we have had. Liquidity will continue to be constrained. The amount of money in private equity deals is unlikely to return to the levels experienced earlier this year. Tighter credit conditions and weakness in the housing market will continue to be a drag on the economy, making it more difficult for earnings to surprise on the upside. All this should result in a reduced appetite for risk and a better environment for higher quality stocks.

Since the market's pullback in mid-July, the spread between the bulls and the bears has narrowed considerably, making sentiment a positive factor in our outlook. Monetary factors also remain positive and valuation remains neutral. Although we expect we will see some additional fallout as a result of the credit markets and a slower economy, we are generally constructive on the market through the end of the year. Our strategy continues to focus on quality companies that can deliver solid earnings growth even when times get tougher.

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