



Index	Quarter Return	YTD Return
DJIA	4.2	13.3
S & P 500	2.0	9.1
NASDAQ	3.8	11.9
Russell 2000	-3.1	3.2
MSCI EAFE	2.2	13.2
Lehman Bros. Aggregate Bond	2.8	3.9
Consumer Price Index	0.1	3.5



Third Quarter Investment Commentary

The market volatility, credit crunch, housing market collapse, and hedge fund debacles make it hard to believe the overall stock market was in the black during the third quarter. But it was, with the S&P 500 gaining 2%. Moreover, through September the index is up 9.1% on the year. While the broad market managed nice gains, there was a wide degree of variation across asset classes. Growth benchmarks did quite a bit better with larger-cap growth stocks generally delivering strong returns during the quarter. For the year large company stocks are ahead of smaller company stocks by a wide margin after seven consecutive years of out performance by small cap stocks. International stocks gained over 2% in the quarter, extending their run of impressive returns. With the exception of high-yield bonds, most other fixed-income asset classes had a solid quarter with investment-grade bonds climbing almost 3% and emerging-market short-term bonds returning almost 5%.

The Economy – Where have we been?

When it comes to assessing the investment future, it would be immensely helpful to be able to accurately predict the health of the economy. One thing we know is that credit is the lifeblood of the economy and it has become less available than it was. The ease with which homebuyers could access capital will be remembered as one of the defining characteristics of the last few years, as it contributed to an unprecedented surge in housing prices in many parts of the country. At the same time, in the leveraged buyout market, loans were written on remarkably generous terms which spurred acquisitions and boosted stock prices.

Unfortunately, when excesses end, things don't immediately return to "normal." Often they go to excess in the other direction. This type of snapback triggered much of the volatility during the third quarter as investors retreated from holding riskier debt and most institutions were inclined not to lend to each other. This cascaded into broader risk avoidance on the part of investors, hedge funds, and other financial market players who had previously played an important role in expanding the amount of available credit. The result was that credit, which as noted is crucial to the economy, was sharply restricted for a few weeks. With the Fed's decisive action in September to cut the federal funds rate, things have settled down, but they have not returned to normal. Capital will no longer be available to certain groups of borrowers and it will be costlier to other groups. This we can count on and it's not entirely a bad thing because excess liquidity was leading many investors to make imprudent investment decisions. But, what is bad is a seizing up of the credit markets in a credit-dependent economy. It seems highly probable that the economy will, at the very least, experience slower growth.

The Economy – Where are we going?

The question now is how long it will take to fully return to a normal credit environment, which is necessary to mitigate recession risk. If there are other events that shock the markets and cause another retrenching, recession risk will rise further. Because there is a lot of credit extended through hedge funds (which lend their capital) and structured products (e.g., collateralized debt obligations which slice and dice loan portfolios to create different risk trenches that are then repackaged and sold to investors), it is difficult to know the magnitude of some of the more questionable debts, who holds them, and whether they are in strong or weak hands. This in turn makes it hard to know if there may be blow-ups yet to come.

With the housing ATM machine largely shut down and home sales severely slumping, the economy is faced with the possibility of a material cutback in consumer spending—the primary driver of domestic economic growth. However, the global economy has been quite strong and is less dependent on the U.S. than it used to be. In general, due to improved economic and growth fundamentals, the emerging markets are playing a much more important role in the global economy.

The weakness in the dollar, as long as it doesn't turn into a rout, is like an interest rate cut. It will help U.S. export growth and contribute to the bottom line of U.S. firms that do business globally. Meanwhile, a dollar collapse is unlikely because this outcome would be very harmful to the global economy and central banks around the world would take extreme measures to avoid it.

Looking at the current environment, we know the economy could fall into recession. But, more likely, we will avoid recession and we could be surprised on the upside with the aid of Fed easing, a weaker dollar that stimulates exports, and global growth driven by emerging markets.

Our disciplined approach allows us to capture long-term returns that are driven by factors in which we have the highest confidence while still keeping risk in line with each portfolio's risk profile. Although, there have been some reduction in earnings estimates the overall valuation of stocks is still reasonable. This gives us a measure of downside protection in the event that there are unforeseeable surprises such as an economic recession or severe financial blow ups.

For quite some time we've believed most equity asset classes to be in a fairly priced range suggesting that over the long run we will make more money in equities than we would in more defensive asset classes. We've been rewarded for taking that view. But we have also recognized that, as always, there are troubling risks. Equities have not been priced at levels that were low enough to ignore these risks and entice us into more aggressive positions. And we have been concerned about the likelihood that corporate earnings growth will slow from recent historically high levels. So we've stayed relatively neutral in terms of our risk exposure.

Final Thoughts

With three-quarters of the year in the books, returns have been decent, though we admit it doesn't feel that way given the turbulent summer and high level of uncertainty. So far each of our asset allocation plays has added value in 2007, with commodity futures, and large-caps (we are over weighted versus small-caps) all outperforming the asset-class alternatives that we would have owned in our default allocations. We continue to have a high level of confidence in each of the funds we own.

As always, we will continue to challenge the assumptions that underlie our view, consider new information as it becomes available, and stay intellectually honest in making well-reasoned investment decisions for our clients.