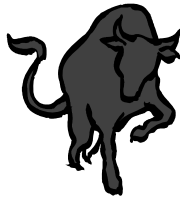




## 2007 4<sup>th</sup> Qtr. *ReView of the Markets*



Index	Quarter Return	2007 Return
DJIA	-3.9	8.9
S & P 500	-3.3	5.5
NASDAQ	-1.8	9.8
Russell 2000	-4.6	-1.6
MSCI EAFE	-1.8	11.2
Lehman Bros. Aggregate Bond	3.0	7.0
Consumer Price Index	0.7	4.2



### Fourth Quarter Investment Commentary

Without a doubt, investors will remember 2007 as the year that the housing market collapsed and triggered a credit crunch. As credit tightened and the housing market suffered, investors became more and more worried about the overall economy, triggering stock declines for many consumer goods companies. While all this was going on, U.S. exports were booming and reached an all-time high of 12.1% of GDP. Not surprisingly, companies with significant foreign-based earnings did well including energy, technology, and materials companies. Overseas stocks also delivered great returns. Related to the overseas story was the continuation of demand for energy and raw material commodities from China and other high-growth developing countries.

There was action in the bond market also. Investors first worried about inflation and then recession. At times they worried about both. The 10-year Treasury yield ranged from a high of 5.25% in June to a low of 3.85% in November. But outside of the government bond market, perceived credit risk rose, leading to underperformance and very poor returns in the lower quality markets.

### 2008: Big Worries...Any Opportunities?

We try to base our investment decisions on a long term outlook. This allows us to focus on underlying fundamentals and valuations – the factors that ultimately drive returns – and distance ourselves emotionally from the day-to-day “noise” of the markets and the financial media. Over shorter time periods these relationships – among fundamentals, valuations, and

returns – don't always hold. This is the point made in the legendary Benjamin Graham saying: "In the short-term the market is a voting machine, but in the long-term it is a weighing machine." However, we are not totally unconcerned with performance over periods as short as one year because we also manage our portfolios with the aim of controlling risk in the short term.

The question most investors are asking at this point is "will the troubled housing and mortgage industries take down the economy?" The underlying key is consumer spending, which makes up 70% of the economy. The contraction in the housing related industries has a direct impact on employment and spending, but it is the related credit crunch and its impact on spending that could cause the most damage. The impact of hundreds of billions of dollars in loan losses to banks, hedge funds, and other investors means less ability to lend because lenders have less capital. It also means less willingness to lend because of uncertainty about the borrowers.

The problem is that it is difficult to quantify the losses and impossible to confidently forecast how restrictive credit will be and for how long. There is also fear that credit problems will spread to other areas. At this point, it seems pretty clear that banks will have more write-offs over the next few months or quarters, and structured investments (securitized pools of debt), which are often highly leveraged, will suffer through more ratings downgrades as collateral values decline further. Certain types of hedge funds, which have exposure to these vehicles, are likely to suffer sizable losses in coming months. Moreover, a predisposition to conservative lending will make the Fed's job harder. This suggests that the current trend of less credit and higher costs probably has a way to go. This is true, not just in the mortgage market, but in the consumer and small-business loan market as well. The bottom line is that investors hate uncertainty and, until investors feel that we have a handle on credit risk, the markets will be in for a rocky ride.

It is easy to dwell on the negatives, and this is a common investment mistake that we've seen (and sometimes made) over many years. It is not a foregone conclusion that the negatives will drag the economy into recession – though some slowdown seems quite likely. Although the employment market is showing some signs of slowing, it remains healthy. Emerging markets continue to thrive and are a positive for the global economy. The Fed and other central banks are aware of the economic risks and are using interest-rate policy and other measures to improve liquidity. They will not stop until they have an impact; though how quickly this will happen, and how successful they will be, is not yet clear. Overall, global liquidity remains strong – with large foreign exchange reserves and huge growth in government controlled investment funds created to invest foreign exchange reserves. As we weigh the information we have, we know we can't confidently predict how the macro picture will play out. However, we believe the odds of a meaningful slowdown, or even recession, have increased from a few months ago, though a recession is still far from certain.

That there is big-picture uncertainty is nothing new – it's always a given. And as always it begs the question "what is priced into the markets?" This is important because, at times, the relationship between the macro climate and security prices disconnects. When fear is high, investors avoid risk, driving up the prices of safe assets and driving down the prices of riskier assets – often to excess. The result is that riskier assets usually are bargain priced when fear is

high, and vice versa. Presently most “risky” assets (anything other than cash and investment-grade bonds) do not appear to be expensive and some sectors look to be very cheap from a long-term standpoint.

## **U.S. Equities**

Any evaluation of stocks must consider earnings. We know that earnings are highly correlated with the economy, so the weaker the economy, usually the bigger the earnings decline. Economic strength is all a matter of degree, so even without an official economic recession, an anemic period of growth could trigger an “earnings recession.” That would be a headwind for stock prices. It is very possible that there will be some near-term earnings risk, depending on how much economic growth slows and for how long. The Fed would help offset some of the damage in an earnings recession by taking already low interest rates even lower. This seems the direction we are headed, and it would likely encourage investors to look to recovery and also ensure that fixed-income investments would not provide much competition. However, lower rates will not eliminate the risk to stock investors from a material earnings recession.

What level of risk is priced into stocks? As of this writing, stocks are down about 15% from their peak. Most of our valuation measures suggest the market is in the range of fair value and some measures suggest stocks are at bargain levels.

However, corporate earnings and profit margins are well above their long-term historical average, and if we adjust for a gradual reversion, stocks look to be closer to the expensive end of a fair-value range. We believe that profit margins are unsustainably high and, therefore, earnings growth will be subpar – either the result of a short, but sharp, drop in earnings, or from a sustained period of slower growth. If this happens, stock returns over the next few years are likely to beat bond returns but would probably not reach double-digit levels.

There is also the possibility of upside surprise. The Fed could engineer a soft landing, with money growth, ample global liquidity, emerging market demand, and productivity increases that spur another several years of earnings growth and healthy stock returns.

We continue to like large-cap, blue chip stocks much more than small-cap stocks – from a valuation, earnings, and cyclical perspective – and overall we remain neutral on equities in line with the defensive posture we initiated a year ago.

## **Foreign Equities**

As a generalization, foreign equities can be divided between developed and developing (emerging) markets. Developed market equities had a great year in 2007 and have outperformed U.S. stocks for six consecutive years. However, both Europe and Japan, like the U.S., are showing signs of an economic slowdown. We also view currency as a potential risk. The strong decline of the dollar versus the euro suggests that the euro is now overvalued and there is a risk of a currency reversal. So while the momentum could continue for a while, there is not a strong fundamental or valuation case to be made, and currency losses are a risk.

Emerging markets have performed even better than developed markets and have now made up for their collapse in the late 1990s. Valuations versus the U.S. are now expensive compared to history. However, we believe that the vast improvement in emerging-market fundamentals has justified at least part, and possibly all, of their higher relative valuations. However, though we wouldn't be surprised to see the fundamentally driven momentum in these stock markets continue for a while given the sharp price spike – the index is up about 40% (average annual return) over the past five years – we are cognizant of short-term risk. Finally, there has been a belief that foreign economies have now exhibited so much intrinsic growth that a U.S. slowdown would not have much impact on them – we do not fully subscribe to this. Overall, for the first time in many years, we are neutral with respect to both developed and emerging markets.

## **Fixed Income**

Investment-grade bonds are the primary way we hedge against recession risk, and, though Treasury yields are quite low now, some slices of the investment-grade market offer more attractive yields. As for taking much credit risk to capture extra yield, in our view it's too late in the economic cycle. High-yield defaults are likely to rise over the rest of the cycle. Losses from defaults and price declines, as yields have to rise to attract investors, will hurt returns. We don't think current junk bond yields are high enough to compensate us for this risk.

## **Conclusion**

Most equity-oriented asset classes are priced approximately at fair value. Large-cap stocks remain attractive relative to small-cap stocks – so the former are overweighted and the latter underweighted in our portfolios. But our overall equity exposure is neutral.

Economic risk has risen and recession is a clear possibility, though not necessarily a high probability. However, we are taking a close look at the risk exposure in our portfolios and assessing whether we should increase our defensiveness even more. However, clients should understand that the possibility of a rough year lies ahead. They should also understand that this is not an outcome that can be predicted with high confidence. We've been surprised by positive market returns many times over the years. So we focus on doing our best to maintain adequate risk protection over a one-year time horizon, based on the risk tolerance of each investment profile, while keeping our eye on the more important goal of long-term returns.

If the current turmoil in the credit markets and/or an economic downturn triggers a further sell-off, we are likely to see tactical opportunities created in several asset classes or at a stock-picking level. In fact, at a stock-picking level we may already be at this point, with some large financial firms selling far below what their fair value would be if (after the credit crisis abates) their earnings return to normalized levels. However, given the fear and uncertainty, it is likely to be a while before their stocks reflect their longer-term potential. At an asset-class level we are not there yet – and we may not get there soon – but for long-term investors, market turmoil can create great opportunities.