



---

## MARKET COMMENTARY

October, 2007

---

The seemingly ordinary 2% return of the S&P 500 during the third quarter of 2007 masked what was a quarter of considerable financial market turmoil, a quarter where the downturn in the US housing market steepened and finally spilled over into the broader consumer and financial markets. Within the quarter, the S&P declined at one point over 10% but rallied from mid August to a positive return for the quarter as an accommodating and financially savvy Fed and ECB moved decisively with timely actions to right the ship.

It was a classic summer panic driven by liquidity issues, a result of a lengthy period of leverage indiscriminately applied throughout the financial system: to wit, poorly underwritten home loans (pundits said that loans for four bedroom homes were given to people who couldn't afford a chicken coup), overreaching hedge funds, aggressive private equity deals, and speculative financial instruments sold to undisciplined buyers. An indicator of financial excess, the word "sub prime" was burned into the American nomenclature in the same way that "Long Term Capital", "Drexel Burnham/Michael Milken/LBO" and "dot com" were in the last two decades.

As we have long discussed, the market hates uncertainty almost more than concrete bad news. During the market slump that bottomed in mid August, uncertainty reigned. Hedge funds, foreign banks,

mortgage companies and home builders warned of various problems. In this sudden credit crunch some companies and funds collapsed in short order. As usual, the financial press responded with a daily barrage of Chicken Little, hyperbole, and fear. In early August, the Fed and the ECB made their first moves to ease the stress in the financial markets and restore confidence and faith in the markets with significant liquidity injections. Finally, in mid September, the Fed moved to reduce the fed funds rate and the discount rate by 50 basis points. The market reacted with a surge back to new highs. The Fed was engaged and on our side.

As with any nervous market, headline risk remains with us as some of those hurt by liquidity and credit issues report their losses or mark their assets to market. Additionally there remains some risk that the issues are more systemic to the financial system or could lead to a consumer based recession. However, we believe that the timely and decisive steps taken by the Fed (and other central banks) and their commitment to use the Fed's full powers to combat both the credit crunch and the threat to our economy posed by the housing downturn, makes this negative case very unlikely. And despite the headlines, most of corporate America is well capitalized, very liquid and their business prospects are strong. It is important to note that the global economic boom continues and companies selling into that boom should

continue to prosper. Our portfolios derive about 40% of their profits from outside the U.S. and those earnings are growing at a considerably faster rate than domestic earnings. GE, Citigroup, Goldman Sachs, Proctor & Gamble, Chevron and Intel on average earn 50% of their profits overseas.

Finally, as the ISI Group has noted, financial crises that do not lead to recession are actually good for stocks (e.g. 1995 Mexico debt crisis, 1998 Long Term Capital financial and currency crisis, 1984 Continental Illinois bankruptcy). Following a 10% correction, markets have typically moved up more than 20% in the ensuing six to nine months. As Warren Buffet noted in a recent interview, longer term investors will look back on this market correction as "no big deal." In fact, market dislocations present good buying opportunities.

Your portfolio is comprised of globally dominant, cash rich companies competing for, and winning, faster growing international opportunities. In most cases, the cheaper dollar only makes them more competitive and improves their prospects. Importantly, the dollar also makes some great American business franchises attractive to international companies looking to acquire quality, stable assets cheaply. As we have said before, the ongoing and dramatic industrialization of the developing world remains the predominant trend in the global economy and financial markets. The bumps we experienced in the third quarter of 2007 are indicative of the significant pitfalls equity investors must endure from time to time in a global economy. For the long term investor, we continue to believe there remain substantial potential rewards.

### Market Balance Sheet

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates	Budget Deficit Surplus	Geopolitical Stability
Economic Growth/Industrial Production	Economic Growth/Consumer Spending	Energy Prices
Liquidity (Monetary Growth)	Inflation	Regulatory Environment
Fiscal Policy	Dollar	
Valuation	Employment	
Profit Growth/Margins	Free Trade Protectionism	
Productivity →		
Demographics		

#### POSITIVE

Interest Rates

Still relatively low and favorable to equity valuations. Inflation expectations are moderating with the economy. Also of note is a relatively flat yield curve with the 10 year treasury somewhat below the current 4.75% Fed Funds rate. We believe the Fed will probably lower rates at least one more time later in the fourth quarter or early next year.

Economic Growth	<p>Should remain healthy while moderating to the 1 ½% – 2 ½% range for the next few quarters. We see the odds of a domestic recession as very low.</p> <ul style="list-style-type: none"> <li>➤ Profits and corporate liquidity remain strong, and support both             <ol style="list-style-type: none"> <li>1) increased business investment and higher employment</li> <li>2) strong dividend growth and share repurchase.</li> </ol> </li> <li>➤ The housing downturn and the slowdown in domestic economic growth has been accompanied by an increase in defaults in the highest risk mortgage lending area called sub prime loans. There will continue to be losses associated with defaults, foreclosures and asset write-downs, and some spill over in the consumer segment of the U.S. economy.</li> <li>➤ As we have previously noted, the economic growth driver has shifted from the consumer to capital spending and industrial production, and toward innovation, small business, and more entrepreneurial activity.</li> </ul>
Fiscal Policy	Taxes on dividends and capital gains at lowest levels in over 60 years. Two year extension of the tax cuts on dividends and capital gains through 2010 would likely be threatened by a new administration.
Valuation	Very reasonable at about 16 times estimated 2007 S&P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields about 4.65%, and is thus valued at roughly 21.5 times “earnings” (its coupon).
Profit Growth/ Margins	Profit growth slowing to 5% range over the next few quarters; profit margins continue at very high levels aided by ongoing gains in productivity, but could come under some pressure from a rise in both employment and raw material costs.
Productivity	Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; will moderate somewhat as economic expansion matures and we move closer to full employment.
Demographics	Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.
Liquidity (Monetary Growth)	Money growth is accelerating in the U.S. and global liquidity is very strong. Global broad money (e.g. MZM) is robust, growing at better than 10% on a year over year basis according to ISI Group.

**NEUTRAL**

Inflation	Cyclical inflationary pressures are subsiding. We believe any pick up in inflation will prove temporary, as the global economy exerts relentless pressure on prices. In particular, China remains the dragon slayer of inflation, exerting downward pressure on U.S. wages and manufacturing. Low global bond yields and a relatively flat yield curve in the U.S. also indicate inflation is contained.
Dollar	Dollar weakness could ultimately lead to higher short term interest rates in order to lend support to the dollar. The weaker dollar helps U.S. multinationals, but our trade deficit remains stubbornly high despite the competitive advantages of a lower dollar. It is also worth noting that about 30% of our trade deficit is due to imported oil (net energy imports are currently running at an annual rate of around \$300 billion). This is a structural deficit, which has exploded in the last couple of years due to the declining dollar and doubling of global oil prices.

Employment	The employment picture remains quite healthy, with 52 consecutive months of job growth. The 4.7% overall unemployment rate is low by historical standards, and remains near a six year low. Still, employment growth has been less robust than in typical recoveries, and the pace of job growth is likely to moderate further over the course of the year.
Free Trade/ Protectionism	Free trade and free market oriented reforms were given a boost by recent election results in France, Japan, Canada and Mexico.
Budget Deficit	Currently running at less than 1.5% of GDP and in an improving trend due to surge in federal tax receipts. Still, we would like to see more spending restraint. Bigger issue is the persistent growth of medical care costs and the long term liability of retirement in our aging society.

**NEGATIVE**

Geopolitical Stability	Iraq continues to be plagued by terrorism and sectarian violence. The global terrorist threat will be with us for some time as will the issue of a nuclear Iran. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.
Energy Prices	After a significant decline late in 2006, oil prices have rebounded to over \$80/Bbl, while North America natural gas prices have actually declined to below \$7/Mcf due to persistent high storage levels. Without a global economic slowdown it is difficult to make a convincing case for a sustained collapse in energy prices. Additionally, in order to be economically viable, most non conventional hydro carbons (e.g. Canadian Tar Sands, coal to liquids, biofuels) need a sustained price of about \$50 per barrel of oil.
Regulatory Environment	Federal and state investigations continue to impact individual corporations and entire industries; recent concerns focus on the area of stock options and executive compensation. Changes in Congress also raise the possibility for increased regulation and tax policy changes for certain industries.