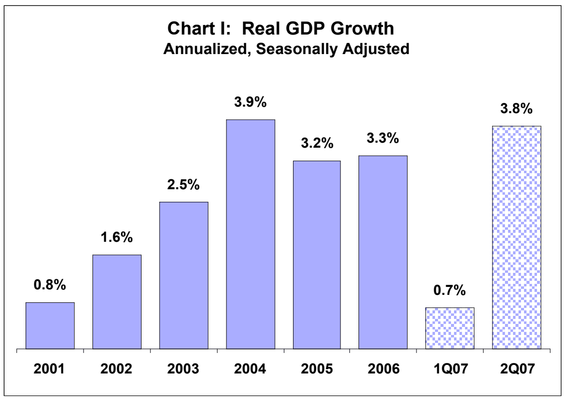
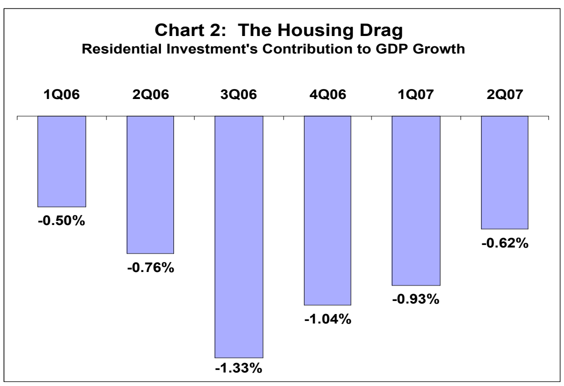
Investment Update
Third Quarter 2007

The Economy

Late in September, the final revision to GDP growth data for the second quarter confirmed that the U.S. economy has been rebounding quite strongly. Importantly, this report also broke the pattern that we saw in the prior two quarters of initial growth estimates subsequently being revised sharply downward as more data became available.





Strong exports, helped by a sliding dollar, were a bright spot during the quarter, as was capital spending by businesses. Consumers continued to spend, though less enthusiastically, and this important indicator needs to be watched closely. Housing, though still weak, was less of a drag than in prior quarters.

The rebound in growth was welcome news, but it has recently been largely overshadowed by concerns about the ongoing effects of the soft residential real estate market and of the July and August disruptions in global credit markets.

As housing prices stopped rising and housing turnover slowed over the past two years, more frequent mortgage delinquencies and foreclosures have exposed the ugly side of the real estate boom. New financing techniques and mortgage vehicles, relatively easy monetary policy, low interest rates, and remarkably lax underwriting practices of some mortgage lenders and brokers created a whole new class of borrowers/home buyers with the sub-prime mortgage. It is now clear that many of them will not be able to repay their mortgages as agreed.

While the actual dollar losses will ultimately be manageable, because sub-prime borrowers have represented a relatively small part of the whole mortgage market and because securitization means that any losses will probably be widely dispersed, the adjustment process has rippled through the credit markets with surprising speed. In August, the markets for many mortgage-backed securities simply dried up, and liquidity soon disappeared from the broader asset-backed securities markets too.

Nevertheless, even at the height of the disruption, investment-grade corporate borrowers were still able to borrow in the bond market and home mortgages were still available to credit-worthy borrowers. Outstanding bank loans have been expanding rapidly, meaning that banks are still willing to lend. In other words, this has not been the sort of credit crunch that has often preceded a recession, as available credit has not dried up entirely. Credit has just become more expensive, if it is available at all, for many riskier borrowers. This increase in the cost of credit has cooled the M&A boom and placed a number of pending leveraged buyout deals under a cloud.

The Federal Reserve's surprise rate cuts in August and September and similar swift actions from the Bank of England and European Central Bank probably helped to stabilize the credit markets, but credit will be more expensive for many borrowers and the market will be much more selective about who will be able to borrow.

The global economy continues to grow, with particularly strong performances from the developing world's economies. Our exports to the rest of the world and capital spending by businesses should help to keep our economy growing despite the housing drag and weaker consumer spending. However, the third quarter's GDP number will no doubt be influenced by fallout from sub-prime mortgage losses and the credit market hiccup. We would not be surprised to see a weak one-quarter result, much like we saw in the quarter following the New Orleans hurricane disaster, even though we think that the overall trend of moderate growth is intact.

Regarding the housing market, it is important to keep the gloomy headlines in perspective. For example, the S&P/Case-Shiller National Home Price Index for July was widely reported to have declined about 4% from the previous July, one of the largest year-over-year declines ever. But the declines in the index this year follow a decade of 8-20% annual increases that leave most homeowners with significant equity in their homes even if prices sink further. With employment still healthy, it is difficult to come up with a scenario under which prices at the national level decline much more. The situation is entirely different in those regional markets where speculative building and buying was rampant, and in those markets sellers are often cutting prices dramatically.

Equity Markets

Volatility returned with a vengeance in the third quarter. From the middle of July until the middle of August, most of the major market indexes fell sharply with declines ranging from 8% for the Dow Industrials to 16% for the emerging markets. But just as quickly, as credit markets began to function more normally again, stocks bounced back and the major indexes are all solidly in positive territory for the year. With the exception of the NASDAQ Composite, the major indexes are at or near all-time highs.

Table 1: Equity Market Performance

	12/31/06	6/30/07	9/30/07	2007 % Chg	3rd Qtr % Chg
Dow Jones	12,463	13,409	13,896	11.5%	3.6%
S&P 500	1,418	1,503	1,527	7.6%	1.6%
NASDAQ	2,415	2,603	2,702	11.8%	3.8%
Russell 2000	788	834	805	2.3%	-3.4%
MSCI EAFE	2,074	2,262	2,300	10.9%	1.7%

The Energy sector continued its strong performance, responding to high energy prices and strong demand for related services. Materials and Industrials continue to be primary beneficiaries of both strong global growth and rising capital spending by U.S. businesses, and earnings and stock price performance for these groups have both benefited. Weaker performance for the Consumer Discretionary sector reflected the pullback in consumer spending this year. The ending of the housing and buyout booms has and will continue to hurt earnings for many companies in the Financials sector.

Earnings for U.S. companies in the S&P 500 Index are expected to grow roughly 7% in 2007 and 8% in 2008. Taking into account these fairly modest expectations and valuations of about 15x forward earnings for the broad U.S. market, we think that emphasizing those sectors and companies that have some exposure to the higher growth rates of economies outside of the U.S. should be rewarding.

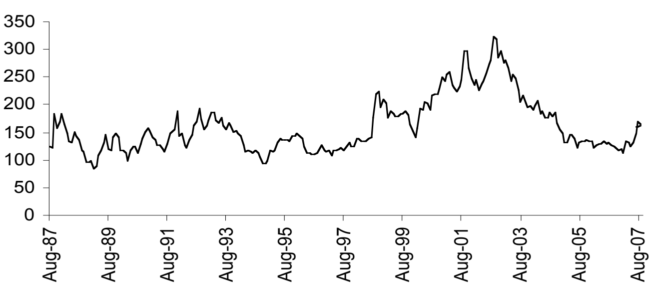
Fixed Income Market

For quite some time, a very flat yield curve has meant that there has been little to be gained from investing in longer-term versus short-term bonds. Also, the difference between yields on Treasuries and yields on corporate bonds has been so narrow that there has been little incentive to take on the additional risks that corporate bonds are subject to.

Now, with the Fed having lowered short-term rates and with longer-term rates moving up, the yield curve is more normally sloped and higher yields can be had by investing in the intermediate part of the curve than at the short end.

Chart 3: Corporate Yield Spreads

Corporate Yields - Treasury Yields (b.p.)



Source: Baseline

Although yield spreads have widened following the July and August credit market turmoil, they are still relatively narrow by historical standards. We would still be strongly inclined to limit any non-Treasury purchases to government agency bonds, investment-grade corporate bonds, or high-quality municipals.