



PORTFOLIO INSIGHT

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Chilton Capital Management's View on Financial Services

Volatility took a toll on most financial stocks during the quarter, but financial services companies focused on mortgage lending and structured credit products fared the worst. Chilton has maintained a bullish stance on the global investment banks and asset managers for several years—businesses with little or no exposure to mortgages. On balance the more diversified investment banks emerged relatively unscathed and provided generally decent quarterly reports. We continue to believe the outlook for global investment banks and asset managers remains robust for several reasons: the intergenerational transfer of wealth fosters a growing demand for personal financial advice, the emergence of Sovereign Wealth Funds and the growth in emerging capital markets.

Demographic trends benefit investment banks and asset managers. Baby Boomers are inheriting what has been called “the largest transfer of wealth in history” from their parents, the Greatest Generation. According to a Boston College study, almost \$1 trillion is expected to transfer to the next generation every year through 2050. This reinforces our view that the need for quality financial advice and asset management services should persist.

These same demographic trends may restrain earnings growth for traditional banks. Boomers are likely to de-leverage by reducing debt as they age, limiting the need for traditional lending. Other banking businesses such as collecting deposits and mortgage origination are slow growth businesses with minimal barriers to entry. De novo banks are opening around the country, all with the same business model—pick off deposits and loans from the “Big” banks by offering better customer service. Overall, the traditional domestic banking industry looks to be a battleground for market share and one that does not currently appear attractive for investment at this time.

The Rise of Sovereign Wealth Funds

The U.S. Treasury Department estimates that global foreign currency reserves now stand at \$5.6 trillion. Foreign reserves are typically invested in liquid and safe investments such as U.S. Treasury bonds and are designed to back their currency. However, petro-dollars and foreign trade surpluses have generated significantly more cash than is needed to maintain liquidity and currency support. According to the U.S. Treasury, foreign reserves growth is accelerating and has grown 20% annually since 2002. This is compared to 6% annual growth from 1997 to 2001.

The rapid growth in excess foreign currency reserves has funded government investment vehicles called Sovereign Wealth Funds (SWFs). SWFs control over \$2.5 trillion in assets

and coupled with foreign reserves, total assets controlled by governments are about \$8.0 trillion, or 8% of global financial assets. The table below represents the distribution of the largest SWFs.

Countries with the largest Sovereign Wealth Funds			September 2007	
Country	Fund	Assets \$B	Inception	Origin
UAE	Abu dabi Investment Authority	\$875	1976	Oil
Singapore	Government of Singapore Investment Corporation	\$330	1981	Non-commodity
Norway	The Government Pension Fund of Norway	\$327	1990	Oil
Saudi Arabia	Saudi Arabian funds of different types	\$300	na	Oil
China(PRC)	China Investment Company Ltd & Central Hujjin Investment Corp	\$300	2007	Non-commodity
Kuwait	Kuwait Investment Authority	\$250	1953	Oil
Russia	Stabilization Fund of the Russian federation	\$132	2003	Oil
Singapore	Temasek Holdings	\$100	1974	Non-commodity
Australia	Australian Government Future Fund	\$51	2004	Non-commodity
U.S. (Alaska)	Alaska Permanent Fund	\$40	1976	Oil
Qatar	Qatar Investment Authority	\$40	2000	Oil
Brumei	Brumei Investment Agency	\$30	1983	Oil
South Korea	Korea Investment Corporation	\$20	2005	Non-commodity
		\$2,795		

Source: Morgan Stanley, *The Economist*, Sovereign Wealth Fund web sites

The difference between foreign exchange reserves held by central banks and SWFs are that the former can be characterized as serving short term currency stabilization and liquidity management while the mandate for SWFs is to maximize long-term returns, typically by buying riskier assets than the foreign reserve funds could. Governments seeking higher than risk-less returns for these SWFs have fueled a wave of buying in riskier global assets such as non-government debt, real estate and equity investments. For example, earlier this year a Chinese SWF invested \$6 billion in Blackstone Group just before it went public. Abu Dhabi recently announced it is buying 7.5% of Carlyle Group for \$1.4 billion and Qatar purchased a 24% stake in the London Stock Exchange. The Chinese National Oil Company (CNOOC), a state controlled entity attempted to buy Unocal in 2005 but was rebuked by Congress on national security grounds.

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Emergence of a Global Transaction Market

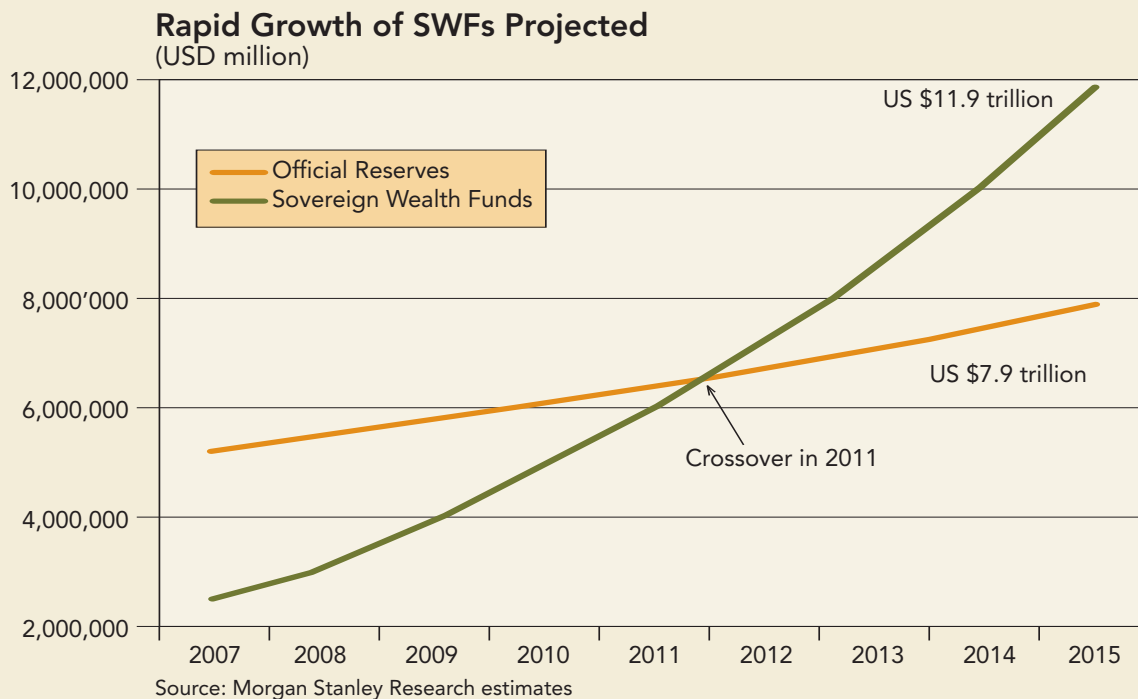
The rise of the SWFs and their mandate to commit equity capital has defined the global transaction market. We believe that the need for global advisors of capital will continue to benefit the multinational investment banks. As SWFs look to commit equity capital in both public and private markets, the global investment banks will likely provide advice representing either buyer or seller, or providing money management services.

Are these SWFs oceans of “smart” money or just “big” money chasing higher returns? The answer should not matter to the global advisors of capital, as the investment banks are merely concerned with the volume of transaction advisory business.

A Shift in the Balance of Power?

Just a decade ago, General Electric, American International Group and Berkshire Hathaway were the leading “Spoils of Crisis” investors, offering capital for bail-outs during times of financial stress. In return for providing capital these companies were handsomely rewarded in excess of what could be achieved in a normal investing climate. For example, Berkshire Hathaway bought pipeline and utility assets at fire-sale values after the Enron meltdown. However, the competition from foreign capital via SWFs may alter the landscape for these companies and narrow the excess returns earned from investments during crises. We believe SWFs were sizeable buyers of risky assets during the market turmoil of the third quarter.

The tremendous sovereign wealth distributed globally has perhaps now changed the balance of power. As seen below, SWFs are predicted to appreciably outgrow foreign reserves over the next decade:



The rise of the SWFs should provide a considerable and lasting impact on the investing environment. We believe SWFs will undergo a massive asset allocation shift from riskless to risky assets causing heightened demand for equity assets globally. Because of the demand for risky assets, Morgan Stanley's research team is calling for slightly higher bond yields, lower equity risk premiums and consequently higher P/E ratios over the next decade.

The demand for premier assets may increase as SWFs look to both enhance returns and diversify away from their oil-driven origins. Demand for well-known high quality equities should favor U.S. large cap stocks. Scarcity values may rise for trophy assets as “buckets” of risk capital focuses on “thimbles” of premium assets.

Growth in Global Capital Markets

Market reforms, transparency and growth of capital are legitimizing emerging capital markets in areas such as China, Russia and the Middle East. Opportunities in merger and advisory business, capital raising and project finance should provide growth for leading global investment banks.

An example of this trend is the emergence of a corporate bond market in China. Heretofore, Chinese regulations effectively permitted a minimal bond market. The current value of China's corporate bond market is about \$70 billion or 3% of GDP. In comparison, the U.S. and Japanese corporate bond markets are about 150% of GDP. A recent regulatory change will allow Chinese corporations to increase debt issuance. The emergence of the Chinese bond market creates a tremendous opportunity for global investment banks to underwrite debt.

A similar story is unfolding in the Chinese equity markets. Recent market reforms that eliminate the two-tier state and private ownership structure will encourage mergers and acquisitions that were previously prohibited by the restrictive share structure. Again, we believe this favors global investment banks.

Conclusion

In conclusion, we believe that the magnitude of the coming intergenerational transfer of wealth, the rise of Sovereign Wealth Funds and the development of global capital markets bode well for our global investment banks and asset managers.