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Portfolio Insight

3rd Quarter 2008

The third quarter saw acceleration in the de-leveraging of the US economy. Domestic equities were off sharply for the three months ended September 30, 2008 with the S&P 500 Index off 8.5%, bringing the year-to-date decline to just short of 20%. International stock markets suffered as well, with all major foreign markets including China (down over 50%), Japan (down 22%), and the EU (the UK, French, and German equity markets all down over 30%) registering declines year-to-date in excess of all US broad stock market indices.

FINANCIAL TURMOIL

US and global equity markets are reflecting concerns that turmoil in the financial system will lead to an abrupt widespread economic slowdown. At the heart of ongoing upheaval are US residential mortgages, a $12 trillion market now severely impaired by the bursting of a housing bubble that developed during 2000-2006. The impact of current dislocations are persistent and intense; Lehman Brothers filed for bankruptcy late summer, AIG's financials have crippled the company, the federal government has intervened on behalf of Fannie Mae and Freddie Mac, and Washington Mutual and Wachovia were forced to sell at fire-sale prices. To give some context to the overall picture, the US residential mortgage market at $12 trillion is larger than the entire national debt of $9 trillion, AIG is the world's largest insurer, Fannie Mae and Freddie Mac are primary guarantors of most US mortgages, and Washington Mutual and Wachovia are among the largest of US domestic banks. Although effects of these failures continue in the form of dramatically reduced lending, we believe there will be few, if any, more significant failures among the remaining major players in financial services as they have taken steps to bolster their financial conditions.

"A contributor to the current capital shortfall among financial institutions was a change in accounting standards in early 2007, called FAS 157"

GOVERNMENT INTERVENTION

Amidst this backdrop, the US Treasury and the Federal Reserve are scrambling to lessen the impact of the financial crisis. The recently-enacted and controversial $700 billion Emergency Economic Stabilization Act is designed to arrest the negative feedback loop of credit losses leading to financial firms reducing loans, an action which in turn leads to economic weakness and further credit losses. While it has been characterized as a bailout plan by some, it does have the potential to allow the US financial system to work through the current crisis. Unlike banks, the Treasury has the ability to hold mortgage securities that over a longer time frame (measured in years not months) could recover a significant portion of their lost value. Banks and other financial firms that sell these securities to the Treasury therefore have a better chance of surviving the current crisis but do so at the expense of losing the full benefits of any long-term recovery in the prices of these securities.

Another option being considered is temporarily suspending an arcane accounting rule which could be beneficial in the short-term. A contributor to the current capital shortfall among financial institutions was a change in accounting standards in early 2007, called FAS 157. Very simply, FAS 157 required financial institutions to account for investments using market prices rather than historical cost, a change intended to encourage transparency. However, with so many of the investments illiquid, the mandated 'mark to market' led to significant changes in US financial institutions' balance sheets and, most importantly, capital ratios. The new accounting standard has had the unintended consequence of contributing to overall market turmoil.

GLOBAL ECONOMIC SLOWDOWN

The US consumer has felt increasing financial distress for more than two years. The resulting reduced demand for imports has led to a drop in global demand for commodities, energy, basic materials, and industrial equipment. Demand for each of these has been a key contributor to growth for a number of economies, especially emerging markets like China, India, Russia and even those of Eastern Europe. Russia and the Middle East are seeing lower revenue from oil and gas exports as prices fall. Much of Western Europe is now suffering its own housing and financial setbacks, which are aggravated by slowing exports and soured investments in US mortgage products.

We have been concerned for some time about inflationary implications due to higher energy and food prices and a weak US dollar. While a number of current remedies for the distress in the credit markets carry with them risk of inflation, we suspect any inflationary pressures are now likely to be felt a few years out. The next year or so is more likely to be a period of disinflation, driven by falling commodity prices, further price declines in the US housing market, and a global economic slowdown.

Credit growth has slowed dramatically as credit providers are tightening lending standards and raising capital to improve their balance sheets. As in most cycles, lending standards swing between being very loose to becoming very tight. The tightening process will make it more difficult for companies that need credit to grow. The economic slowdown will probably occur across the globe, putting a premium on companies that are able to adjust to new realities without the benefit of easy credit. We remain focused on finding and owning shares of companies whose prosperity is not predicated on optimally favorable credit conditions.

"The picture is not entirely bleak. Outside of a few highly leveraged financial institutions, US corporate balance sheets on average are in excellent shape."

CHANGE AFOOT

Senators McCain and Obama are currently in a close race in the US Presidential election with both promising change from Bush Administration policies. We believe we have positioned our clients' portfolios to benefit from investment opportunities likely to arise as the new President brings the "change" promised in the campaign. As before, one element of our overall strategy is the identification of companies with unique products or technological innovations that suggest the possibility of growth of earning in excess of GDP. We believe that approach will be rewarded. Society faces a number of challenges needing solutions which innovation can provide.

Little question remains that the future will bring increased regulation of financial markets in the US. Whoever is elected President will want to be perceived as helping to correct imbalances in the financial markets and will most likely support increased regulation of some type. The benefit of regulation is that it may reduce the potential for future debacles. The downside is that new regulations may lower returns for banks due to anticipated restrictions in the use of leverage. New regulations may also have negative unintended consequences much as did the adoption of FAS 157. Our research and portfolio management team is continually evaluating how new regulation will impact the companies we own and where new investment opportunities or risks may arise.

INVESTMENT IMPLICATIONS

The current downturn in the US stock market dates back to October 2007. Past bear markets have either been sudden - usually a swift drop confined to three months - or a more drawn-out falling off lasting roughly 18 months. Over the past 50 years the average peak-to-trough drop is 32%, with at least 10% occurring in the final month. The current deterioration is rapidly approaching the average loss, and late August through September has seen an additional sharp fall in prices. The average rebound at the conclusion of a bear market averages 15% over a three-month period. In other words, over 30% of the average bear market decline is reversed within one quarter once the market turns around. While we think weakness in the US economy could persist for several more quarters, the stock market will anticipate any improvement in fundamentals and has the potential to rally sharply.

The picture is not entirely bleak. Outside of a few highly leveraged financial institutions, US corporate balance sheets on average are in excellent shape. The following table shows that non-financial corporations have significantly less debt relative to equity and cash than in past recessions:

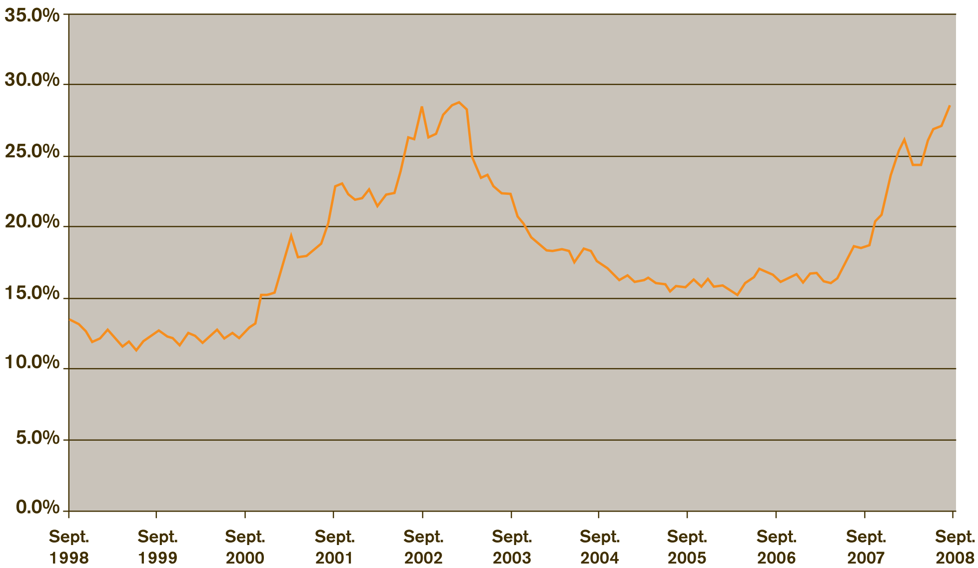
Past Recessions	Cash/ Debt	Debt/Equity (Ex-Financials)	Capex/ Depredation	Pretax Margins
1990 to 1991	14.7%	86.6%	1.46	7.4%
2000 to 2001	23.1%	76.2%	1.36	8.7%
Current	37.8%	56.8%	1.34	10.7%

Source: Morgan Stanley

The amount of cash sitting on the sidelines is another potential bullish sign for a market rebound. The following chart shows the ratio of money in cash and money market funds relative to the entire capitalization of the Wilshire 5000. The chart shows that cash levels are similar to those at the end of 2002, which marked the end of the bear market brought on by the bubble in technology stocks. The movement of cash into equities starting in 2003 was a major force in strong equity returns from that date through 3Q 2007.

As economic growth slows, it will be important for investors to identify companies across different industries that can take market share and maintain pricing power. A key underpinning of our process is to properly assess and understand where any one company is in its growth cycle and constantly look for

CASH ON SIDELINES
(Total U.S. Money Market Funds as % of U.S. Market Capitalization)



Source: Bloomberg LP

companies that have significant growth potential. Beyond this we also screen to identify and purchase companies that (1) do not rely on significant debt or have significant near-term debt maturities, (2) are not totally dependent on GDP growth, (3) will not be hurt by new waves of regulation, and (4) meet our qualitative criteria but whose prices have been driven below intrinsic value. As recent market events have shown even large, well-established companies that are leaders in their industry can face enormous challenges during times of economic stress. Identifying companies that can make opportunities out of current economic conditions remains an ongoing priority for all members of our equity research team.

In summary, we are witnessing the world's largest margin call. The heavy amount of leverage carried by US financial institutions has in many cases been their undoing. Financial derivatives designed to manage risk have instead exacerbated debt loads. For many years these financial institutions (including hedge funds) used excessive leverage to make oversized profits by incurring what were deemed to be manageable risks. Investors who have taken a lower-risk approach to investing and have owned quality securities may not be enjoying the market volatility right now, but they will live to see another day. Many of those that relied on debt to drive returns will not.