

### Third Quarter 2007 – Market Review

The third quarter provided more “excitement” than most investors were looking for. The apparent cause of all the commotion was activity in the sub-prime mortgage arena. Until recently lenders seemed more than willing to lend money to borrowers with little, bad or no credit. Normally, lenders would require documentation of the borrower’s income as protection against default. But with the booming real estate market, some lenders felt that as long as the mortgage loan was backed by real estate, it was safe.

Many mortgages were being written on 100% or more of the home’s value with no income verification required of the borrower. These loans were among the so-called sub-prime mortgages gobbled up by investors. As defaults rose and it became difficult to discern which mortgages were sound and which were not, panic spread. Investors were asking, “Who owned what and how much?” Escalating anxiety caused the market for most loans to freeze up and the demand for safer U.S. treasury securities to soar. Adding fuel to the fire, many large mutual funds and institutional investors decided to reduce risk in their portfolios by selling investments that were both mortgage and non-mortgage related.

By mid-quarter, most developed equity markets had fallen about 10% and emerging stock indexes fell about 20%. On September 18<sup>th</sup> the Federal Reserve lowered a benchmark interest rate by ½%, reducing the cost of borrowing and restoring some confidence to the markets. The world’s stock markets responded favorably to the Central Bank’s action and by the end of September were already at or near their all-time highs.

Over the course of the quarter, large cap stocks were up 2.0% and up 9.1% in 2007. Over the last one, three and five years, large cap stocks are up over 15% per year in each of those time periods. The ten year return, however, isn’t quite as stellar at only 6.6%, just edging out the ten-year return on government and corporate bonds of 6.2%.

Asset Class Returns - Before the Impact of Inflation						
	Investment Type (Index)	3rd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
<b>Equity</b>	Large Cap (S&P 500)	2.0%	16.4%	16.2%	15.5%	6.6%
	Mid Cap (S&P 400)	-0.9%	18.8%	15.7%	18.2%	11.6%
	Small Cap (Russell 2000)	-3.1%	12.3%	13.4%	18.8%	7.2%
	International Equities (MSCI EAFE)	2.2%	24.9%	23.2%	23.6%	8.0%
	Commodities (Dow Jones AIG)	6.2%	17.0%	9.5%	14.1%	7.6%
	Real Estate Investment Trusts (NAREIT)	2.6%	5.7%	19.0%	21.5%	12.2%
<b>Bonds</b>	Gov’t & Corporate Bonds (Lehman Gov/Credit)	3.0%	5.1%	3.7%	4.0%	6.2%
<b>Cash</b>	Cash (T-Bills)	1.3%	5.2%	4.1%	2.9%	3.6%
	Inflation (CPI)	0.4%	3.1%	3.3%	2.9%	2.6%
Asset Class Returns - After Inflation						
	Investment Type (Index)	3rd Qtr	1 Yr	3 Yr	5 Yr	10 Yr
<b>Equity</b>	Large Cap (S&P 500)	1.7%	13.4%	12.9%	12.5%	3.9%
	Mid Cap (S&P 400)	-1.2%	15.7%	12.4%	15.3%	9.0%
	Small Cap (Russell 2000)	-3.5%	9.3%	10.1%	15.8%	4.6%
	International Equities (MSCI EAFE)	1.8%	21.8%	20.0%	20.6%	5.3%
	Commodities (Dow Jones AIG)	5.9%	13.9%	6.3%	11.2%	5.0%
	Real Estate Investment Trusts (NAREIT)	2.2%	2.6%	15.7%	18.6%	9.5%
<b>Bonds</b>	Gov’t & Corporate Bonds (Lehman Gov/Credit)	2.6%	2.0%	0.4%	1.0%	3.6%
<b>Cash</b>	Cash (T-Bills)	1.0%	2.1%	0.8%	-0.0%	1.0%

Alternatively, both mid and small cap stocks fell during the quarter, shedding 0.9% and 3.1%, respectively. After averaging more than 18% per year for the last five years, it doesn't surprise us to see some weakness in these names. After all, even small fast growing trees don't grow all the way to the sky. U.S. Real Estate Investment Trusts (REITs) rose 2.6% in the third quarter, but are down 3.5% year-to-date. Global REITs rose 3.7% during the quarter and are up 4.4% for the year.

Foreign stock returns continued to be strong, but perhaps not quite as strong as they appear. The MSCI



Royal Bengal Tiger, India

EAFE Index, a broad international index, is up 13.2% thus far in 2007. Stocks in the Euro zone are up 18.5% and Asian stocks excluding Japan have gained 16.4% in 2007. Some of these gains have accrued to U.S. investors because of the falling U.S. dollar. Taking out the impact of currency reduces the gains to about the same level as U.S. large cap stocks, up about 9% - 10% year-to-date. Unfortunately for investors, timing the direction of foreign currencies is very difficult, if not impossible. And, the gains from a weakening dollar will be offset by currency losses should the dollar eventually strengthen.

Emerging market stocks are on a tear, soaring 14.4% in the third quarter and posting a 34.5% gain year-to-date. Thus far in 2007, Chinese stocks are up 72.5% and Indian stocks are up 40.4%. In Latin America the markets are up 40.6% in 2007, with Brazil up 58.6% and Peru leading the way with a 104% gain. Even stocks in Turkey (which borders Iraq to the north) have enjoyed a good year, gaining 64.5%.

While year-to-date emerging markets have posted stellar results, the five-year returns are even more amazing for some markets. For example, Chinese stocks have now averaged 48.7% returns per year over the last five years! The five year returns in India are virtually the same at 48.4%. Argentina, Brazil, Colombia, Peru, the Czech Republic, Turkey, and Egypt have all seen five year returns surpassing 50% per year. We point these figures out to sound a cautionary note: If you



Rio de Janeiro, Brazil

know folks who are heavily invested in these markets, they should exercise caution, because booms don't last forever. And, in financial markets, the exceptionally good times have a way of coming to an abrupt end. Can we expect this boom to end any differently?



The 8,099 strong Terracotta Army near Xi'an, China

**“The Chinese use two brush strokes to write the word ‘crisis.’ One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger - but recognize the opportunity.”**

**John F. Kennedy**