



THIRD QUARTER RECAP

The third quarter was a tumultuous period for global equity markets. As Peter McKay wrote in the Wall St. Journal: “Navigating the financial markets in the third quarter was like taking an airplane trip through a storm. It was a relief to reach the final destination, but the journey wasn’t especially pleasant.” After initially rising in July and hitting a record high in the middle of the month, the S&P 500 index then moved sharply lower. From mid-July to mid-August, the index fell more than 9% from its peak, while small and mid capitalization indices also dropped precipitously. The sharp decline in the equity market was triggered by mounting issues related to the housing and sub-prime mortgage markets. Stock prices then began to rebound in August as the Federal Reserve lowered the discount rate and investors anticipated that the Fed’s next move would be to lower the federal funds target rate. The market continued to rise in September following the Fed’s greater-than-expected 50 basis point cut in the federal funds rate. In conjunction with reducing the federal funds rate from 5.25% to 4.75%, the Fed stated on 9/18/07 that while economic growth was moderate during the first half of the year, “the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. Today’s action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruption in financial markets and to promote moderate growth over time.” In spite of the gyrations in equity prices, the S&P 500 finished the third quarter with a gain of 2.0%. Mid and small capitalization stocks did not fare as well, however, recording small losses for the three month period. The Russell Mid Cap index declined 0.4% during the third quarter and the Russell 2000, an index measuring small cap performance, fell 3.1%.

PERFORMANCE MATRIX

Index	2007 3Q	2007 YTD
S&P 500	2.0%	9.1%
Russell 1000 Growth	4.2%	12.7%
Russell 1000 Value	-0.2%	6.0%
Russell Mid Cap	-0.4%	9.5%
Russell 2000 (small cap)	-3.1%	3.2%
MSCI EAFE (international, \$, net)	2.2%	13.2%
Lehman Municipal Bond	1.8%	2.0%
Lehman Aggregate Bond	2.9%	3.8%

Despite periods of extreme volatility, the U.S. bond market, performed well during the third quarter and generated positive returns. Credit markets tightened up and investors fled to the safety of treasuries. Risk was “re-priced” and non-investment grade spreads widened dramatically in a very short period of time. A number of high profile leveraged buyouts (LBOs) were put on hold and buyout activity diminished sharply because of difficulty obtaining financing. Lending terms also became less liberal. The decline in the level of buyout activity, an important underpinning of stock market strength in the first half of the year, also hurt equities. While acquisitions will continue to occur in the future, the number of large LBOs is likely to diminish. In addition, going forward the prices paid for companies, and the returns on those investments, are likely to decline from currently inflated levels because of reduced access to leverage.

International stocks were also extremely volatile during the third quarter and, despite continued healthy economic growth, were adversely impacted by the fallout from the sub-prime mortgage market in the U.S. The return of the MSCI EAFE, an index that measures developed market returns, was +2.2% measured in U.S. dollars, comparable to the return of the S&P 500 during the same period. However, measured in local currency, the MSCI EAFE index declined 2.5% in value. International stocks derived substantial benefit from a 5.3% fall in the value of the Trade Weighted Dollar Index during the third quarter. (The dollar closed out the third quarter at an all-time low against the euro as it remained under pressure because of the Fed’s recent interest cut.) The primary drag on the index was the Japanese market, which was down for the quarter. European equities were up modestly, while emerging market equities followed up their strong performance in the second quarter with another sharp increase in September after the Fed lowered interest rates. The MSCI Emerging Markets Index returned 14.5% during the third quarter with notable strength in Asia.

EQUITY MARKETS

Similar to the prior quarter, the energy, technology and industrial sectors led the market higher in the third quarter. Energy stocks continued to benefit from escalating oil prices, while the technology and industrial sectors experienced the positive effects from increased capital spending and healthy export demand. The spot price for West Texas Intermediate (WTI) oil was up 17% during the three months ending September 30th. Inventories remain tight and OPEC’s decision to raise output by 500,000 barrels/day starting November 1st was viewed by the market as insufficient to meet rising demand. In contrast, investor concern about the ramifications of the sub-prime mortgage fallout and the mortgage exposure of financial institutions, hurt the performance of the financial sector. A number of hedge funds experienced significant losses because of leveraged bets on the sub-prime market. Credit markets, especially high yield, temporarily seized up leaving the banks on the hook to provide several hundred billion dollars in leveraged buyout financing. In addition to financials, the consumer discretionary sector also posted declines during the quarter. Retail and housing related stocks were especially weak. Investors remain concerned that consumer spending will wane as housing prices deteriorate and more homeowners’ income is siphoned off by rising mortgage payments. At this point, the housing market continues to deteriorate with no bottom in sight. Selected regional markets are suffering from heavy oversupply that is likely to take multiple years, and further price declines, to absorb. As a result of this situation, the housing market continues to pose downside risks to economic growth.

S&P 500 SECTOR PERFORMANCE

S&P 500 Sector Performance	Sector Wt. (9/30/07)	2007 3Q	2007 YTD
Energy	11.7%	9.8%	28.7%
Materials	3.2%	4.9%	22.4%
Industrials	11.5%	5.9%	17.5%
Consumer Disc.	9.2%	-6.3%	-3.6%
Cons. Staples	9.5%	4.8%	10.0%
Health Care	11.6%	1.0%	7.2%
Financials	19.8%	-4.3%	-5.0%
Info. Technology	16.2%	6.3%	16.2%
Telecomm. Serv.	3.7%	2.1%	17.9%
Utilities	3.4%	2.0%	11.0%
S&P 500	100.0%	2.0%	9.1%

Source: Standard & Poor's

Growth stocks outperformed value at the large, mid and small cap levels for the three-month period ending September 30th and widened their year-to-date performance lead. For the first nine months of the year, the growth indices have outperformed the value indices by between 670 and 1200 basis points. The evidence continues to mount that after seven years of value besting growth, the pendulum is swinging back to growth. During the third quarter, the largest differential occurred in the small cap space where the Russell 2000 Growth Index was flat and the Russell 2000 Value index lost 6% in the quarter. Nine months year-to-date, small cap growth has returned 9.3% while small cap value has declined 2.7%. The large exposure of value funds to the financial sector, combined with heavy technology weights in many growth portfolios, have been the primary factors that have contributed to the disparity in style performance. Following historical patterns in periods of economic uncertainty and market turmoil, large cap stocks outperformed small caps during the quarter, though the best performing domestic sector year-to-date has been mid cap growth.

FIXED INCOME

Deterioration in the sub-prime mortgage market filtered into credit markets in the third quarter of 2007, leading to a flight to quality that benefited U.S. Treasuries and sovereign bonds (bonds issued by a national government, i.e., government bonds). Demand waned for corporate bonds and commercial paper as investors became wary and required higher premiums for taking risk. In response, corporate bond issuance slowed and some investment banks were forced to carry corporate bonds on their balance sheets because of a decrease in investor appetite. Investors became concerned over the lasting effects of the credit turmoil, as well as the magnitude, and extent, of exposure that banks

have to the sub-prime mortgage market and what effects it would have on lending. Money market rates were volatile as investors abandoned most short-term money market instruments (e.g., commercial paper) in favor of short-term U.S. government bonds. As a result, the yield curve steepened to its highest level in nearly two years. However, by the end of the quarter, the Fed's decision to infuse liquidity into the banking system and to reduce the federal funds rate revived investor confidence. The credit market recovered and most sectors generated positive returns. Global bonds were the best performing sector, posting high single-digit returns, while U.S. Treasuries achieved mid single-digit gains, their best quarterly performance since the third quarter of 2002. Exposure to long duration bonds benefited the most from the flight to quality. This flight to quality aided the performance of Treasury Inflation Protected Securities (TIPS), though a decrease in inflation expectations was a damper on their overall return.

Municipal bonds experienced considerable volatility during the third quarter, suffering from the side effects of sub-prime mortgages in July and August, and municipal yields decoupled from Treasury yields. This created a favorable environment for municipals as their yield relationship relative to Treasuries reached multi-year highs and a buying frenzy for municipals subsequently ensued in September. Our municipal bond managers were able to capitalize on this anomaly and generate gross quarterly returns in the 2.0% to 2.5% range. The high yield municipal sector significantly underperformed the investment grade part of the market and declined slightly for the quarter. Our expectation is that the high yield municipal sector will rebound in subsequent quarters.

OUTLOOK

At the end of our second quarter market commentary, we posed the following question: "Is there a blowup lurking that could have ramifications for the rest of the financial system? We don't know." Now we know. The implosion of the sub-prime mortgage market has indeed had significant negative ramifications for a number of hedge funds, financial institutions, and, most importantly, the financial markets. The tightening of credit conditions has caused a change in the Fed's mindset. Rather than continuing to hold interest rates steady, the Fed has cut interest rates and become more accommodative in order to ward off a potential recession. Despite escalating oil and food prices, core inflation has been relatively well behaved over the short-term. Although the Fed remains concerned about inflation, the recently benign numbers have provided the FOMC (Federal Open Market Committee) with some room to maneuver. In retrospect, the environment was behaving very much as the Fed had anticipated until the sub-prime debacle occurred. However, the impact of this debacle (which has probably not fully played out), combined with the worsening housing recession, implies lower economic growth over at least the next few quarters, an increased level of risk for the economy and corporate earnings, and greater uncertainty for the equity market. In fact, most economists have ratcheted down their near-term forecasts for U.S. growth to approximately a below-trend 2% growth rate. At the same time, though corporate earnings have consistently exceeded expectations, year-over-year profits in the third quarter are projected to be flattish and the outlook is clearly now more uncertain. In addition, mergers and acquisition activity, which has been one of the important drivers of equity market performance, will no longer be supportive of stock prices to the degree it has been in the past. Offsetting these negatives, the consumer has thus far remained fairly resilient because of strong income growth, job growth remains moderate, and the unemployment rate is still reasonably

low. By historical standards, equity valuations are close to average and certainly not excessive compared to the prior March 2000 market peak.

Weighing all these factors, we would expect the financial markets to remain volatile over the short-term. With the S&P 500 up 9.1% year-to-date through the end of September, our original expectation of mid-to-high single digit appreciation for all of 2007 still seems reasonable. The third quarter rebound in the bond market, and the ratcheting back of economic expectations, also makes us more confident that low-to-mid single digit fixed income returns can be achieved.

OTHER MATTERS

In accordance with SEC regulations, we request that you contact us in the event that there have been any material changes in your financial circumstances or investment objectives, or if you wish to impose any reasonable restrictions on the management of your accounts or modify existing restrictions on the management of your accounts.

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