

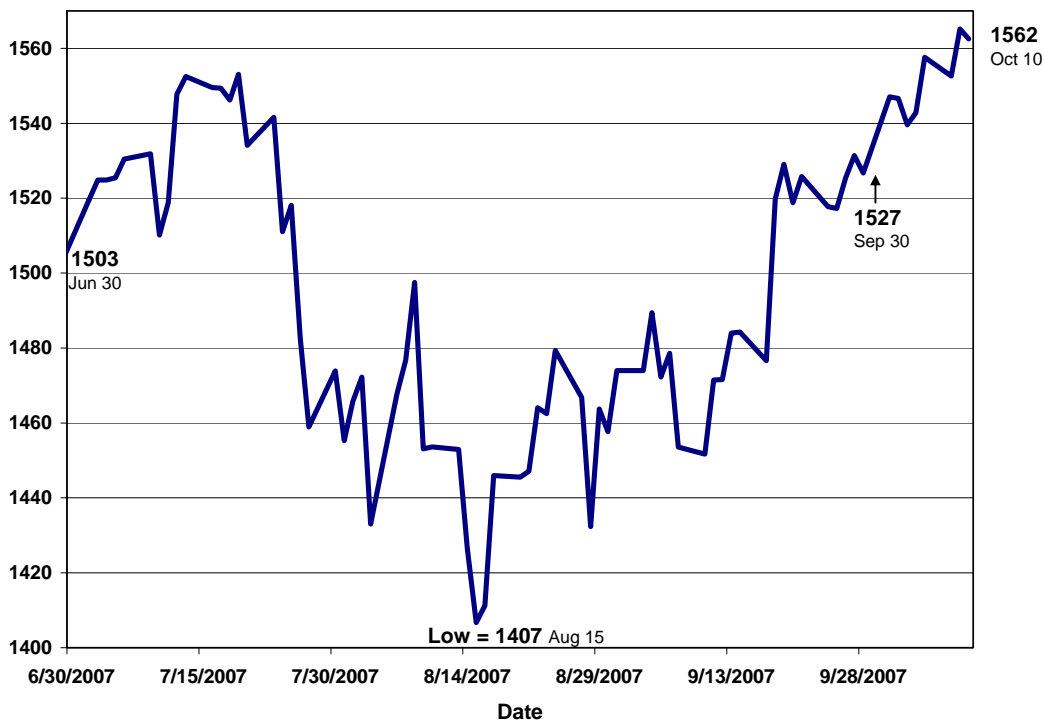
Q3, 2007 Market Commentary

Bob Marshalla
October 11, 2007

Market Review

Economic Turmoil - What a summer! The house of cards that was the housing market finally collapsed. Lenders and investors seemed to realize for the first time that there actually was a lot of risk in many of the loans used to finance the housing bubble. And just as suddenly it dawned on them that credit instruments across the board had been priced way too generously for the risks they entailed. The result was an acute credit crunch. For a short time, there was simply no money available for anything – mortgages, LBO's, bank loans or any of the packaged debt products that had been greasing the wheels of the economic machine. This took the crisis way beyond the sub-prime market, as it threatened to take the whole economy down the dreaded “R” path¹. And that fear brought the stock market down as well.

Figure 1 - S&P 500 in Q3 2007



But soon the Fed came to the rescue² and the feeling of crisis abated. As usual when excesses have been tolerated for too long, the markets over-reacted to the need to change course. Credit

¹ The “R” stands for “Recession” if you didn’t guess.

² In mid September, the Fed cut interest rates for the first time in 3 ½ years. But it also decreased the discount rate and significantly liberalized the terms under which banks are allowed to borrow from the Fed. And maybe most important of all, they changed their policy guidance to place higher priority on addressing growth and credit availability rather than inflation.

spreads *had* been too narrow for several years (at least by all historical standards), but for a short time it appeared no one was willing to buy anything but Treasury securities. While credit spreads are not (and should not) go back to where they were before the crisis, it appears that credit availability is returning to normal. But the bigger issue for investors is keeping an already slowing economy from spiraling into a severe slowdown, or even recession. So far the Fed seems to have done a good job of recognizing that credit availability and economic growth are larger immediate concerns than inflation. There is still a reasonable chance of a severe slowdown, but it now seems there is a better than even chance we will continue on the path of a “soft landing”, which is to say, only a modest and gradual slowdown of growth.

Aside from the Fed’s monetary easing, another factor arguing for economic strength is the rest of the world’s economies being somewhat out of phase with the U.S.. While U.S. growth had been propping up sluggish economies elsewhere for several years, the opposite may be happening now. Continued strong growth in emerging economies and reasonably healthy growth in Europe and Asia, along with an ever lower priced U.S. dollar, have combined to stimulate U.S. exports, and this is one factor helping to keep our economy afloat.

How About the Stock Market? - With all the market turmoil this summer it is hard to believe that the overall stock market was actually in the black for the quarter. The S&P 500 fell by more than 10% intraday between mid-July and mid-August. But it finished the third quarter with a 2.0% gain, and is up a surprising 9.1% on the year as of the end of September. But while the broad market managed nice gains, there was a wide degree of variation across asset classes.

Table 1 – Third Quarter and 2007 Year-to-Date Returns

Asset Class	Representative Index or Fund (blue font)	Third Quarter	2007 Yr to Date
U.S. Equities			
Full U.S. Market	Russell 3000	1.55	8.77
By Market Cap			
Large Cap	S&P 500	2.03	9.13
Mid Cap	Russell Mid Cap	(0.39)	9.48
Small Cap	Russell 2000	(3.09)	3.16
Micro Cap	Russell Microcap	(4.61)	(0.53)
Value & Growth			
Value Stocks	Russell 3000 Value	(0.75)	5.21
Growth Stocks	Russell 3000 Growth	3.85	12.38
International Equities			
Large Cap	MSCI - EAFE	2.18	13.15
Small Cap	MSCI - EAFE Small Cap	(4.49)	6.61
Emerging Markets	MSCI - Emerging Markets	14.42	34.50
MAM Equity Benchmark			
	.8* Russell 3000+.2* EAFE	1.68	9.65
Real Estate			
Equity REIT's - Domestic	NAREIT Equity Index	2.59	(3.46)
	Morgan Stanley US Real Estate	0.28	(2.69)
Equity REIT's - Foreign	EPRA Global ex US Index	4.70	8.72
	Eur. Investors Int'l Property	0.04	4.85

Commodities			
Commodity Futures	Dow Jones AIG Com Index	6.24	10.98
	PIMCO Commodity Real Ret	9.91	13.22
Fixed Income			
Investment Grade Bonds	Lehman Aggregate Bond Index	2.84	3.85
Inflation Protected (TIPS)	PIMCO Real Return Fund	4.84	6.04
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds	7.92	6.06
Emerging Mkts Currencies	PIMCO Developing Local Mkts	4.27	9.89
Floating Rate Bank Loans	Eaton Vance Floating Rate	(1.33)	2.04
Short Term Money	3 Month T- Bills	1.19	3.81

* Based on mutual fund returns. Others are costless market indices.

Large and Small, Growth and Value - Magnifying the trend started last quarter, large caps substantially outperformed small caps. Contrast the S&P 500's 2.0% gain for the quarter with a 3.1% loss for small caps, and an even weaker 4.6% loss for micro cap stocks.³ Also continuing last quarter's trend, growth strongly outperformed value. For the overall domestic market, value stocks were in the red at -0.8%, while growth stocks enjoyed a nice 3.9% gain. Drilling down, similar growth-beating-value results were observed in each of the large, mid and small cap segments, both domestically and overseas. Across economic sectors, the energy sector had the highest returns for both the quarter and year-to-date, while financials and consumer discretionary stocks had the worst returns for both periods.

Investable Real Estate - Domestic REIT's, had a disastrous second quarter, dropping 9.0%. The slide continued in the first part of the third quarter, as they dropped another 9% by the middle of August. But they went on to mount a very nice recovery after that and actually finished the quarter with a 2.6% gain. Still year-to-date the domestic REIT index remains down 3.5%, which compares quite poorly to international securitized real estate, which has gained 8.7%. Real estate has surely had a volatile and mixed performance so far this year.

Commodity Futures - Commodity futures had a great quarter, with our index gaining 6.2%. The PIMCO fund that many of us use to access commodities scored even better with a 9.9% gain. The difference has primarily to do with the PIMCO fund's strategy of investing its collateral in inflation protected securities, a fixed income category that had an excellent quarter (see Table 1).

Fixed Income – Epicenter of the Crisis - Fixed income markets were the epicenter of the recent market turmoil. The largest change this summer was the sudden re-pricing of risk which greatly widened the credit spreads between top quality (i.e., government) debt and virtually all other lower quality credit instruments. When spreads are widening, investors do relatively better in higher quality instruments. A second big change was the Fed's move to decrease short term interest rates for the first time in over three years. And a third important factor was the continuing fall in the value of the U.S. dollar versus most foreign currencies. As a result, the best place to be in fixed income would have been high quality, interest sensitive, foreign currency denominated securities.

³ Micro-caps are defined as stocks with market caps below about \$300 million; small caps are those roughly in the \$300 M to \$2 B range; mid caps comprise the \$2 B to \$11B range, and large caps are those over \$11 B. As a further reference point, the largest stock, Exxon Mobil, has a market cap over \$500B.

The two foreign fixed income funds that we hold in our portfolios each have at least two of those three characteristics⁴, and as a result they have performed the best of any fixed income category that we monitor or invest in. PIMCO Foreign Bonds returned 7.9% in the third quarter alone, while PIMCO Developing Local Markets has earned 9.9% for the year-to-date, both figures topping all fixed income categories in their respective periods in Table 1.

The fixed income category performing the worst for the quarter and year-to-date has been floating rate bank loans. The Eaton Vance fund we have been using (shown in the table because I don't have access to a good market index) lost 1.3% for the quarter. That may not sound too bad, but for this kind of fund it is nearly disastrous. The reason for the poor performance is that these kinds of bank loans are generally lower rated credits. Even though they are senior notes and have very short maturities, they were not immune from this summer's explosion of credit spreads. As I understand it, loan defaults have not been the problem at all in our bank loan fund; rather it has been the market's across the board re-pricing of such lower quality debt instruments. As a result, if these loans do continue to be paid back and do not go into default, their values will eventually return to par, which should result in a recovery of fund share price.

Bank loans have only been an investable product for about twenty years, and they have normally been a very stable category of fixed income. Further, our fund is one of the more conservative representatives of the category⁵. The recent quarter has, quite simply, been one of the worst if not *the* worst this category has ever experienced. Our fund has been in existence for 26 quarters, and this is its worst quarter ever. The second worst was a mere -0.3% loss, and the other 24 quarters all had positive gains.

MAM Investment Moves Paying Off

The recent changes in market direction have not been unexpected. I have been discussing them in reports and portfolio reviews for the past couple years, and have been making asset allocation changes in our portfolios in anticipation of their occurrence. Now, each of these asset allocation plays has paid off nicely for us in the past quarter and year-to-date. These plays include:

- Moving from smaller to larger cap stocks
- Moving towards more growth stocks
- Decreasing our allocations to domestic real estate while introducing and adding to international real estate
- Continuing to keep a quarter or more of both fixed income and equities in foreign currency denominated securities

I have always admitted I did not know when the markets might begin recognizing the valuations upon which I based these moves, and I began gradually making some of the moves before the markets were ready to begin rewarding them. But reward them it has this year.

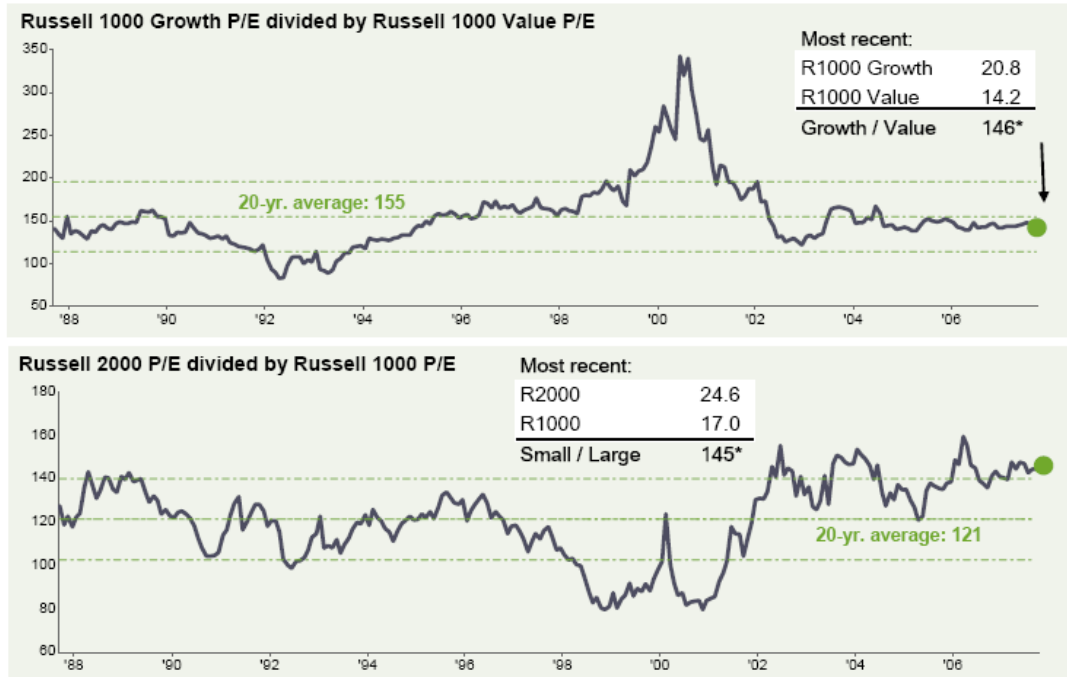
Figure 2 shows a couple of the metrics that cause me to believe the market may continue favor growth and larger cap stocks for awhile longer. The first panel shows the time path over

⁴ The PIMCO Foreign Bond fund has all three noted characteristics, in that it is mostly comprised of intermediate term foreign government issued bonds. The PIMCO Developing Markets fund lacks only the direct interest rate sensitivity, since it is comprised of money market and similar very short term high quality debt securities in emerging market countries.

⁵ Its standard deviation of total returns has been only 2.0% per year the fund has never lost money over a one year period during its 6 ½ years of existence.

the past 20 years of the relative PE ratios of growth stocks as a group to those of value stocks as a group. The second panel does the same thing for small caps stocks to large caps. These graphs clearly show that the seven year run of outperformance by value and smaller cap stocks have moved their relative valuations from very attractive a few years ago to noticeably below their historical norms as of now.

Figure 2 – Relative Valuations: Growth vs. Value & Small vs. Large



Source: Russell Investment Group, FactSet, JPMorgan Asset Management

P/E ratios are calculated for each index as aggregates of the underlying individual company P/E ratios for each respective index. The values are calculated and provided by FactSet, using Russell constituent data, and calculated on a trailing basis.

*Represents the Russell 1000 Growth Index P/E ratio divided by the Russell 1000 Value Index P/E ratio, multiplied by 100 (top) and Russell 2000 Index P/E ratio divided by the Russell 1000 Index P/E ratio, multiplied by 100 (bottom). Data reflects most recent P/E as of 9/30/07.



The Grander Investment Strategy

Tilting, Not Lurching - A question some might ask is why haven't we moved even further in these directions? This could always be asked when one follows a strategy of making only partial or gradual moves. If the market moves in the directions anticipated, critics will ask why didn't you move further or faster? If the market does not move in the direction expected, they will ask why did you move that way at all or why didn't you wait awhile?

Having been trained as a decision analyst, my response is that we always make decisions under uncertainty. We do not gear our strategy to a single forecast of the future; rather, we acknowledge the many possibilities the future holds and design a portfolio to hopefully maximize our *expected* benefits over that range of uncertain outcomes. We are always considering and preparing for numerous future scenarios; what is changing over time is their probabilities, and this is what leads to the "tilts" in our investment strategy that I keep telling you about. As the noted physicist Neils Bohr once said, "Prediction is very difficult, especially of the future."⁶

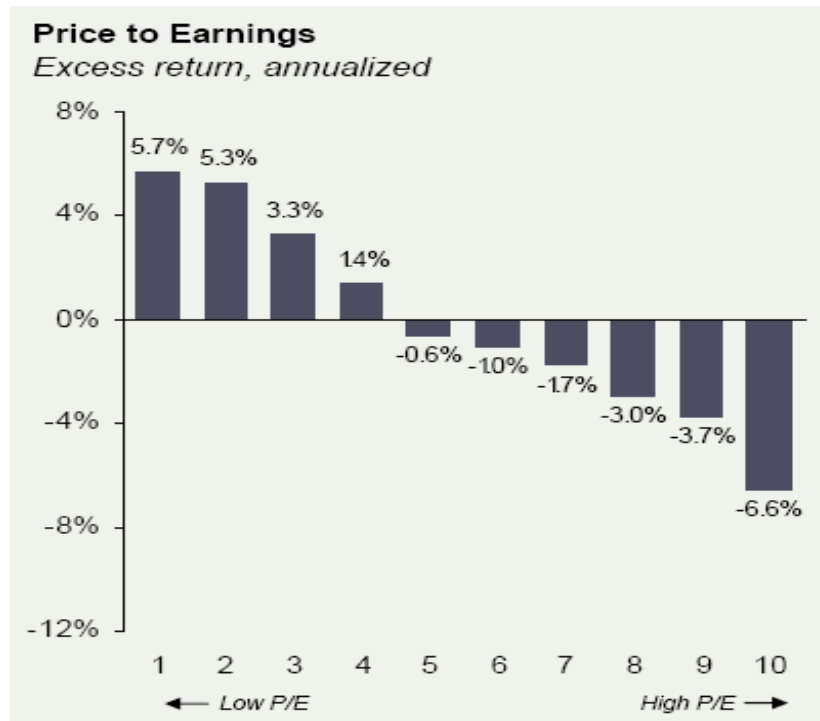
Long Term Strategy Remains the Same - Although we have been tilting towards larger and "growthier" stocks for close to two years, our equity portfolios do remain more value and

⁶ Sounds more like a Mark Twain quote I would have thought.

small-to-mid cap weighted than the overall market, and this continues to be our long term strategy. While market leadership cycles amongst different types of stocks, sometimes for several years at a time, over longer periods, the evidence is very strong in favor of value and smaller caps.

Figure 3 provides one piece of vivid supporting evidence for value investing. It breaks the U.S. stock market into ten deciles by price-earnings (PE) ratios; i.e., decile one is the 10% of all stocks with the lowest PE ratios, decile two is the 10% with the next lowest PE's and so forth. The PE ratio is one of the key metrics used to define value stocks, so as we move from the left to right in the graph, stocks are moving from value towards growth. The heights of the bar graphs for each decile show their investment returns relative to the market average over the last twenty years. The returns can be seen to dramatically favor the lower PE stocks.

Figure 3 – Market Performance by Decile Based on PE Ratios, 1987 – 2007



Source: Russell Investment Group, FactSet, JPMorgan Asset Management

Charts show relative performance of the Russell 3000 Index assigned to deciles on the basis of trailing price/earnings and 12-month price momentum. The time period is from February 27, 1987 through June 30, 2007. Deciles are rebalanced monthly and stocks are equal weighted. Decile performance results have certain inherent limitations. Unlike an actual performance record, decile results do not represent actual trading, liquidity constraints, fee schedules and transaction costs. Past performance is not indicative of future results.



A critical issue is the noted time period – twenty years. Although this graph is based on the past twenty years, 1987 - 2007, we would see the same pattern of returns (i.e., higher returns for value) for virtually any twenty year period we may choose⁷. Although not pictured here, there is similar evidence showing that small cap stocks have exhibited higher long period returns than larger cap stocks⁸.

⁷ Whether and why the future will continue to unfold like the past is of course the \$64,000 question, but unfortunately, that discussion is beyond the scope of this report. If interested, please contact me.

⁸ It is worth noting that the greater returns for small cap stocks do come with greater volatility, but the premium returns for value stocks come with volatilities that are lower or at worst equal to those of growth stocks.

Our continued, albeit lesser, orientation towards value and smaller cap stocks today means that our portfolios may face some headwinds going forward and may struggle to match the market averages so long as current market trends towards growth and mega-cap outperformance persist. Nonetheless I remain as confident as ever in our long term strategy and that it will continue to pay off in the future as it has for most of the past seven plus years.

Final Thoughts

With three-quarters of the year in the books, investment returns have been decent so far; though I admit it doesn't feel that way given the turbulent summer and heightened levels of economic uncertainty. So far each of our recent asset allocation plays has added value in 2007, with larger cap stocks, growth stocks, international real estate and foreign fixed income all outperforming their alternatives. But our plays have been modest tilts, not a change in long term strategy. A "chasing winners" strategy would be unlikely to succeed in the long haul. The biggest factor going forward is the health of the economy, and while no one can forecast the macro economy with confidence, I think the odds currently favor a fairly benign trajectory.

Best Regards,

Bob Marshall,

Your Financial Advisor