January 2007

The Year Ahead 2007

MVCM Annual Market Outlook

Executive Summary

2007 is upon us, and though the "in with the new" sentiment of the new calendar year does not necessarily portend the onset of new trends in the markets, it is nonetheless a good time to take stock of what may lie in store ahead. Taking into account as we always do that the short term is unknowable, here following are the issues weighing on our minds as January gets underway. In brief:

- The US economy should slow down, though not to the point of recession. We are comfortable with 1.7 – 2.0% of real GDP growth, somewhat on the lower side of the consensus range. We think consumer spending, housing and corporate earnings may disappoint by the second quarter while exports could benefit from a weaker dollar.

- We believe risks are skewed to the negative with more likelihood for a confluence of weakness than a show of strength. The US dollar has the potential to cause real problems although we think an orderly decline is more likely with central banks in Asia and elsewhere gradually allowing artificially undervalued currencies to appreciate.

- Global capitalization – or economic decoupling – will be on the radar screen this year as present data are conflicting about the extent to which a US slowdown will spill over into other markets and regions and the extent to which regional capital formation will speed up the decoupling process.

- Geopolitical X-factors may include energy problems related neither to oil nor the Middle East as Europe, Russia and ex-Soviet border states tussle over natural gas supplies. There is no shortage of potential crisis spots in the world, any one of which could bring us to an unpleasant tipping point.

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- In US equity markets we look for another winning year for value over growth and a readjustment from small cap to large cap. On a risk-adjusted basis we would expect large cap to be more attractive than small cap this year while we think growth will lose to value in both absolute and risk-adjusted terms.

- We expect another strong year for international developed and emerging equity markets fueled in part by the dollar's continued decline. Emerging market economies are likely to outperform the G3 (US, Eurozone and Japan). Globalization has affected different countries in different ways and we think this requires a more sophisticated segmentation of international exposure across all asset classes.

- In fixed income as in equities we think it is a good year to concentrate on quality with a bias towards downside protection rather than leveraging our upside. There is a good case to make for non-US and emerging market debt. Average duration in a 3-4 year range can offer potential value capture from declining interest rates with fewer risks in our opinion than further out on the curve.

- Alternative asset classes are increasingly important both for diversification and as a potential source of true excess returns (alpha). We will look to obtain risk tolerance-appropriate levels of exposure to, for example, hedge funds, private equity and structured products in addition to commodities and real estate.

The Economy

"…a dreary, desolate, and indeed abject and quite distressing one; what we might call…the dismal science." – Thomas Carlyle, Fraser's Magazine, 1849

Those who believe Thomas Carlyle summed up the science of economics better than any commentator before or since will be happy with this past year's reinforcement of the sentiment. If the 2006 economy could be personified as a graduating high school senior then her yearbook would read: Most Likely to Never Make Up Her Mind. Inflation was a real threat, except when it was not. The property sector was heading for a Thelma and Louise-style plunge off the cliff, except when it didn't do any such thing. Consumer sentiment was bleak, except when it was as effervescent as a Taittinger cork popping on New Year's Eve. The Fed was sure to start reducing interest rates any time to head off recession, except when it was more concerned about growth or stagflation.

You get the picture. Amidst all of this inconclusive data it seemed that at some point in the middle of July the stock market threw up its hands and said "Well, no-one seems to know what on earth is going on, but it doesn't really look all that bad, so let's party!" And party it did, giving the S&P 500 a tailwind to sail into a 15.79% total return for the year, its best performance for the decade thus far with the exception of 2003, when it was coming off a post-recession trough. Generally Wall Street hates nothing more than economic uncertainty. This time, though, the gloomy Cassandras were shrugged off and the cheerful Pollyannas had their day in the sun.

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In the wake of this cheery second half run a consensus view seems to have gelled around a presumed *fait accompli* “soft landing” engineered by the Fed whereby neither runaway inflation nor a recession nor anything else awful are likely to transpire. GDP growth estimates tend to fall somewhere around 2%. The OECD and Consensus Economics forecast 2.4% and 2.3% respectively, while the Wall Street Journal’s panel of 60 economists polled in mid-December arrived at a 2.2% average for 1Q07 real year on year GDP trending up to 2.9% yoy by the 4th quarter. That same WSJ panel sees generally tame inflation decreasing from the upper end of the Fed’s comfort zone of 1-2%. High single-digit corporate earnings growth, unemployment just below 5%, and a bottomed-out but still-weak housing market complete the story. The happy talk calls this a “Goldilocks” economy – not too hot, not too cold, but just right.

We are not Cassandras but we do see several developments that could throw a wet blanket over Goldilocks. Let’s start with consumer spending. Whenever the legendary American Consumer finally collapses on Heartbreak Hill the four culprits will likely be: household income, consumer debt, national savings and housing prices. Unfortunately none of these indicators looks particularly healthy these days. Household debt is at a record level while the savings rate is negative. Not to worry, says the crowd, because household wealth comes from other sources today and anyway the savings rate is an anachronism. From what sources, may we ask? Housing equity, first and foremost, but wait, aren’t housing prices lower now than they were when we took out all those interest-only mortgages and the like just a couple years back?

Oh, and speaking of paying off mortgages and all of that other consumer debt, how is growth in household income doing? That’s a bit of a tricky question. In the manufacturing and construction sectors it’s pretty dismal and getting worse if the latest figures from the likes of GM, Ford and others are to be believed. Yes, replies the Goldilocks Pep Squad, but that’s about 1/6th of the economy versus the 5/6th share occupied by the services economy, which is humming right along. The ISM Non-Manufacturing Report shows 45 consecutive months of uptrend for services, coming in at a healthy 57.5 for December (above 50 meaning expansion).

True enough – but household income is not perking along in equal proportions throughout a swathe of the US economy that includes Wall Street and Wal-Mart. Bankers in downtown Manhattan are pocketing record bonuses meaning seven figures just for showing up on the deal team, while bedraggled workers at the fabled big-box store are seeing in the New Year with news that their new customer traffic-driven work schedules will leave them in the dark as to whether they need to be picking up in Aisle 4 at the same time as their kids need picking up from school or childcare. The services sector may look rosy on the surface but there’s plenty of dislocation afoot and real economic worries…by those same folks we expect to be doing their patriotic duty by shopping, shopping, shopping.

Just as credit card companies and home equity providers enable Uncle Frank to purchase that must-have Deluxe Chrome Titanium Twin-Cam Turbo Grill and Oven Combo, so too do the People’s Bank of China and the Bank of Japan enable Uncle Sam to run up that must-have current account deficit that at last glance was about $829.1 billion. Except that central banks don’t enforce a credit limit on Uncle Sam the way NationsBank does on Uncle Frank. These central banks have been taking on upwards of $450 billion every year to fund our domestic consumption and foreign policy adventures. In practical terms this state of affairs can last as long as the financing required to sustain US trade deficits is matched by the willingness of central banks to build up dollar denominated reserves.

But the dollar is declining, not cyclically but over a longer secular horizon, and central banks can't prop up the dollar with their own purchases. The bulk of foreign exchange trading is in private, not central bank transactions. Holding assets that are diminishing in value has an economic cost, and the longer the trend continues the higher the cost. This may sound familiar to anyone who was around in 1971 – it's what led to the collapse of the Bretton Woods agreements and heralded a decade of economic stagnation. In fact the current relationship between Asian central banks and the US is known among a number of observers as "Bretton Woods 2" – and that is not meant to be a compliment.

Bretton Woods 2 and downward pressure on consumer spending could materialize as a perfect storm of a worst-case scenario. We should stress worst case, not our base case, because we have no hard, indisputable evidence that either the US consumer or the world's central banks will reach their tipping points in 2007. However it seems to us that the bias is skewed towards the negative because we see even less evidence of one or more variables that will replenish household and national debt, buttress the dollar, turbo-charge productivity and perk up income growth across the swathe of the middle class. We ascribe about a 65% probability to a base case a bit more modest than the consensus – GDP growth of 1.7-2.0% rather than 2.2-2.5%, continued woes in housing, construction and manufacturing, mixed results in service sectors and on the bright side a currency-driven pickup in exports relative to imports (which of course adds to GDP). From the remaining 35% we ascribe perhaps 22.5% downside and 12.5% upside of that.

How we see this playing into Fed policy and market trends will be the subject for discussion in later sections of this report.

Geopolitics

The Middle East is not the only geopolitical cauldron, but we are concerned that stories brewing elsewhere in the world are being drowned out by the daily tribulations in Iraq, the belligerence of Iran, and the unhappy developments we see evolving in Lebanon, Palestine and elsewhere.

"Geopolitics" has become shorthand for "energy" in the parlance of many market pundits. The word immediately brings to mind oil and the Middle East, but these are not the only stories coming up on our radar. There are other geopolitical hotspots lurking as X-factors this year.

Let's start with oil, though, since that was certainly one of the big stories in 2006. Spot prices closed out 2006 right around the $60/bbl level widely believed to be OPEC's long-term target price floor. Since oil prices tend to be closely correlated with global economic growth then we could expect to see a slight demand-induced easing of prices with more subdued global growth. Having said that we would note that growth is more likely than not to remain stronger in the resource-intensive markets of China and India, relative to those of the US and Eurozone, and that would temper demand reduction. We think that OPEC may be prepared to step in with production cuts to achieve price stability around the $60/bbl level.

Another energy-related geopolitical tool is natural gas. The world's biggest gas producer and exporter is Russia, with 22% of total global production and 23% of the world's exports, the vast bulk of which goes to Europe. In fact about 20% of Europe's imports go through one single pipeline called Beltransgaz. The problem is that the Beltransgaz pipeline passes through the country of Belarus, which in December became the latest ex-Soviet territory to feel the pain of Russia's bully-boy regional energy politics. The dispute for now is settled meaning that German homes will have their heat, but this will probably not be the last we hear of gas supplies to Europe before the end of the winter. The spotlight on Russia also highlights a larger problem, which is the expected shortfall of Russia's production capacity relative to import demand over the next 4-5 years. If the European Union is slow to implement a concerted policy of identifying and obtaining alternative sources of gas then the energy crisis we talk about in 2010 may have little to do with the Middle East and lots to do with Russia and Central Asia – replacing one set of crazies with another. Move over Hezbollah and Ahmadinejad, here's Alex "Big Daddy" Lukashenko and whoever succeeds Niyazov Father of All Turkmen!

These issues point to a larger problem – that while much of the instability in the Middle East appears (rightly or wrongly) to be more or less priced into the current outlook there are potential crisis spots that are being overlooked. We highlighted one above. Another is the potential fallout from social unrest in China as its push to the status of economic superpower takes on a life of its own. Beneath all the impressive production and consumption statistics, the record-breaking IPOs and the soaring towers of steel in Shanghai, is a story of massive dislocation as a largely rural, agrarian and economically surplus population tries to find a productive home in the brave new world. The central government in Beijing has to try and balance social harmony with economic reality, and we can't but help thinking of the little boy of Dutch myth who kept his finger plugged in the dyke while the deluge gathered force.

But if there is too little attention being paid to looming problems in geopolitical crucibles like Russia and China, there is practically none being accorded to tragic developments in places like Darfur and Somalia that, apart from being heart-wrenching humanitarian crises, have the potential to open up new fields for extremists and terrorists much in the way that Afghanistan did in the 1990s, and we all know how that turned out. We do not want to come across as being all gloom and doom (no, really), but in truth we are very concerned about the number of trouble spots in the world today, and even more than that we are dismayed and saddened that in the dawn of the 21st century our world continues to suffer from the lethal combination of inhumanity, neglect and indifference that enables these conflicts to fester.

US Equities

In a year where the bias is skewed to the downside we think job number one is to have a strong defense – and this means quality, value, sensible risk and a move towards larger capitalization names.

In 2006 US equity markets would not be stopped by any detracting voices as the Dow Jones Industrial Average rumbled ahead to a succession of all-time highs before closing the year at 12,463.15, a 16.3% annual return. What happens next? As we noted above, the economic CW seems to have formed around a fairly benign year to come – the fabled soft landing – and with this view we are hearing a lot of talk about a "good but not great" performance for the broader markets – S&P 500 maybe in the upper single digits or very low double digits, not much more, but good enough for Goldilocks. In our opinion, that view has more risk on the downside than the upside. And since we are returns-based style investors we are concerned about where the impact is most likely to be felt as much as what the impact will be.

The market is betting on a moderating economy that brings about another 50bp or so of rate cuts by the Fed, so the discount rates for equity valuations are adjusting downwards accordingly. In other words – growth slows enough to bring rates down but not slowly enough to drag us towards recession. But two alternative scenarios are each bad for equity markets. One is that growth surprises on the upside – 3.5-4.5%, and the Fed goes back to worrying about inflation, maybe even hiking rates again. The other is that growth is not just bad but really bad with our perfect storm scenario of a sinking dollar, consumer meltdown and a weak manufacturing sector spilling over into the services industry. In this case investors will surely get their rate cuts but the markets will still get clobbered.

It's not just a soft landing we need. It's landing an Airbus Superjumbo with a picture-perfect touchdown on a moving aircraft carrier in rough seas. Here's hoping – but hope doesn't pay the rent, as someone wise once said. The most important thing in our minds is a good defense.

Let's start with value versus growth. Once again, value stocks handily outpaced their growth counterparts in 2006. The Russell 3000 Value Index was up 22.34% for the year as compared to 9.46% for the Russell 3000 Growth Index. This is no anomaly. Value has outperformed growth pretty much any way you want to look at it over a long period, as the following table shows:

	1 Year	**3 Years**	**5 Years**	**10 Years**
Russell 3000 Value	22.34%	15.20%	11.20%	11.11%
Russell 3000 Growth	9.46%	7.17%	3.02%	5.34%

Bear in mind that this table takes into account both the tech bubble of the late 1990s and its subsequent collapse.

In fact we conducted a study of the value versus growth decision back in the fall of last year and discovered that, since 1979, growth has outperformed value only when the market is coming off a trough year (i.e. the first year of recovery after a negative year for the S&P 500) with the one single exception of the peak of the Internet bubble in 1999. The last post-trough recovery year was 2003. *We see next to nothing that argues for a strong growth stock year in 2007 and our asset class weightings reflect this view.*

The other major component of our US style analysis is capitalization. Here the story is a bit trickier than the value-growth no-brainer. For the eighth year out of the past nine the Russell 2000 Index of small-cap stocks beat the Russell 1000 Index of large caps in 2006 as shown below:

	1 Year	**3 Years**	**5 Years**	**10 Years**
Russell 1000	15.46%	10.98%	6.82%	8.64%
Russell 2000	18.37%	13.56%	11.39%	9.44%

Based on a risk-return study we conducted last fall we think it is reasonable as a default assumption to expect small caps to outperform on an absolute basis. Our study showed that over the period November 1996 – November 2006 the Russell 1000 returned an annual average 9.03% versus 10.04% for the Russell 2000, but the Sharpe ratios (excess return over the risk-free rate divided by standard deviation) were almost equal at 0.34 for large caps and 0.32 for small caps. *We do think that both mean reversion and the current market environment argue that large caps will do relatively well versus small caps in 2007.*

International Equities

Both developed and emerging international markets are underrepresented as an asset class in US diversified portfolios and should be of increasing importance in the coming years.

Investors who stayed out of the international arena in 2006 missed out on a lot. The MSCI EAFE Index returned 26.86% for 2006 and the MSCI Emerging Markets Index returned 32.59%. What is interesting to note is how much of this performance was based on currency rates, as those returns are stated in US dollar terms. On a local currency basis the EAFE index returned 16.94% (a bit higher than the S&P 500) and the Emerging Markets index returned 28.88%. We like international equities for a whole host of reasons, most of which are explained in detail in our December White Paper ***Emerged Markets, Emerging Opportunities***. But if for no other reason, we think a strong weighting in international would be justified because of what we expect to be a secular decline in the dollar over the coming years.

In fact this merits closer attention. Consider the 2006 total returns for the following:

MSCI Index	Local currency terms	USD terms
EAFE	16.94%	28.88%
Emerging Markets	28.88%	32.59%
EM Asia	27.67%	33.22%
EM Eastern Europe	40.12%	46.78%
EM Latin America	37.63%	43.48%
EM EMEA	25.85%	24.25%
EM BRIC	51.29%	56.60%

This chart is really showing two different currency stories. One is the dollar's cyclical weakness against other developed market currencies, primarily the Euro and the British pound. This accounts for the 8% difference in EAFE based on local currency and dollar terms. But the other, more interesting and potentially more troubling story is that being told by the emerging markets currencies such as China's and those of EMEA (which includes Russia, the Middle East and North Africa) that are significantly undervalued versus the dollar and remain so mostly on account of directed monetary policy by these countries' governments and central banks.

The good news is that if countries with major current account surpluses *vis a vis* the US such as China can achieve an orderly appreciation of their currencies versus the dollar then we should continue to enjoy stronger-than-average returns from those countries' equity markets with no material economic disruptions. However regulated currency regimes don't always transition so easily – witness the collapse of Bretton Woods as we noted in this report above. This time around we have huge volumes of US assets – primarily government securities – hanging in the balance and a disruption there could be catastrophic. That's a risk and it is not a trifling one.

The other big top-level question in the international sphere is that of decoupling, or what we call "global capitalization" as described in our December 2006 White Paper. Simply put this addresses the question as to how badly the world will catch cold if the US sneezes. The data are inconclusive and really can be made to tell either of two different stories: (a) the world is much more correlated and interrelated now, so we should expect that the world's largest economy still has the ability to lead the parade, or (b) yes, but the relative share of the world's economy coming from the US continues to decrease, while in places like Asia regional consumer markets are growing quickly and all around the world the ability to access investment capital from local and regional sources is on the rise. We think this second explanation is the way that the world is moving, but the hard evidence will unfold over years, not mere months. *All of this in our opinion underscores not only the desirability of having increased portfolio exposure overseas but also the need to have a more refined strategy taking into account much more than the simple "developed versus emerging" algorithm that is the hallmark of most US portfolios.*

Fixed Income

Super-tight credit spreads and an inverted Treasury curve are seldom seen at the same time – but that is where the markets are today, along with a highly leveraged credit derivative market.

The fixed income market paints a very odd picture where two sides of the market – governments and corporates – appear at odds with each other. The US Treasury yield curve seems poised for a recession – the continuing lower yields out at the 10 year level versus the short end of the curve belie a belief among traders that rates will decline over 2007, an event more likely to transpire the worse the economy is. On the other hand quality spreads between Treasuries, investment grade and speculative debt seem like they can't really go any tighter. So on one hand the market is saying that the economy is going to go sour, and on the other hand that the probability of defaults won't increase by enough to worry about. We wonder, what does the bond market see that we don't? What was in their egg nog cups this past holiday?

It's really a somewhat different version of the same story we have talked about elsewhere in this report. As long as the economy can achieve that picture-perfect landing on the aircraft carrier in choppy seas then all is well. Investors feel comfortable with traditionally riskier assets if they think the stable, low-volatility good times will continue. In the bond market this has been one rationale behind a proliferation of innovative financial products in both the mortgage and the corporate bond market. Innovation is a great thing, but sometimes things develop more quickly than our sober evaluation of their unintended consequences does.

For fixed income securities the crux is the rate of defaults. Bonds are mathematically more predictable than equities in terms of the size and timing of cash flows, except when they default. Defaults in the high yield bond market (less than BBB-rated) have been around historically low levels for the past several years – less than 2% of all outstanding issues. Defaults have declined every year since 2002. Moreover, defaults have spiked up by more than 4% only twice in the past 22 years, those being the recession years of 1990 and 2001. Looking at the credit markets from this perspective it doesn't appear that today's tight spreads are outrageously mispriced, although one would expect to see some widening in a world of slowing economic growth.

There is, however, one caveat to that view, and a potentially troublesome one – leverage. The fixed income markets are highly levered today, which itself is a logical outcome of the proliferation of innovative new products like synthetic collateralized debt obligations (CDOs) and the vast array of new mortgage products that have brought new – and potentially riskier – homeowners into existence over the past several years.

Leverage by itself is not a bad thing, as long as the economic assumptions leading to a particular level of leverage remain more or less intact. It's when that doesn't happen that things get tricky. After all, the definition of leverage is simply borrowing money to make money. If you have all your cash invested in the S&P 500 but think the S&P 500 is still a great investment then you borrow money from somewhere and invest that borrowed money in the S&P 500. By mathematical definition this will result in a higher rate of return than an unlevered bet – or conversely a lower level of return if the bet goes south.

What has happened in the credit markets is that excess returns have diminished with the overall tightening of available yields in the cash market, and investors have taken to leveraging their bond bets – as high as levels of 15 or so times the cash basis of the investment – through synthetic products such as CDOs backed by credit default swaps (CDSs), a derivative fixed income product in which an investor takes on credit risk without actually taking ownership of the underlying asset. The CDS market is roughly 3 times the size of the cash corporate bond market. Again – there is nothing necessarily bad about this *per se*, but the downside of leverage is that it makes bad news much, much worse – see for example Long Term Capital Management circa 1998. "It seemed like a good idea at the time…" goes the refrain.

To make it clear, we do not think that a leverage-induced meltdown in the credit markets is the likeliest scenario for 2007. But the worst case scenario we have noted elsewhere in this document – the confluence of accelerated decline in housing, consumer spending and a precipitous fall in the dollar – feeds into a bad time of it for US governments, corporates, mortgage- and asset-backed bonds.

This makes us reluctant to move far out on the curve to join the folks who have been bidding down yields on the 10 and 15 year bonds. We think it makes more sense to keep a conservative portfolio of short and intermediate term high quality obligations with durations in the 3-4 year range. That will cost us some extra juice if rates fall by a lot across the whole curve, but that's a risk we are very comfortable to take. *To the extent that we see more attractive total return opportunities we think they can be found in a selective look at international and emerging market issues rather than spread-chasing among US sectors.* In particular we think there are some very attractive opportunities in certain emerging market names where risk appears mispriced relative to fundamentals.

Alternative Asset Classes

Alternative assets used to be stocks from Germany or Singapore – but now the product universe is much larger, the complexity and suitability of assets for different investors requires rigorous analysis, and the inclusion of alternative assets in portfolios is more important than ever.

Return, risk and correlation comprise the trinity of investment management. That third component, correlation, is becoming somewhat problematic for money managers seeking to deliver excess returns from properly diversified portfolios. What does this mean? Simply put, correlation is a measure of the degree to which the returns from any one asset in a portfolio vary from those from any other asset in the portfolio. Low correlation between assets is desirable for the goal of diversification. The problem today is that correlations have become higher between different asset classes, as indicated in the example below.

Correlation (R-squared) with S&P 500

	1988-1998	1996-2006	2001-2006
MSCI EAFE	.50	.79	.84
MSCI Emerging Markets	.50	.71	.77
Russell 2000 Growth	.70	.70	.83

An R-squared of 1.0 means perfect correlation, 0.0 indicates no correlation and -1.0 is perfect negative correlation. The point here is that if diversification is harder to achieve from places where it used to exist then new **alternative** asset classes become more important.

Moreover the importance of alternative asset classes is not for diversification alone. The other attractive property of low or zero correlation is as a potential source of excess returns, or "alpha" in investment management parlance. Active portfolio managers seek to deliver returns in excess of their market benchmarks. This can be achieved either by taking on more systematic risk (higher beta than the benchmark), or by leveraging, or by finding sources of uncorrelated returns (alpha).

This is an important point, because it requires that we look at each alternative asset class for its potential both as a diversification tool and as a potential source of alpha. Our universe of available alternative asset classes includes commodity-linked products, real estate, hedge funds, private equity, and structured products providing tailored exposure to specific markets and opportunities. All of these asset classes continue to provide diversification benefits across different market environments, and each is potentially a source of alpha depending on the particular situation at any given time.

Commodities appear to offer a mixed bag for 2007 and we do not believe at present that any exposure is warranted above the view-neutral 5% of portfolio assets that we maintain as a default position for diversification. Oil, as we have discussed above, tends to move in line with global growth and therefore prices should be expected to moderate with lower global growth, though as we noted above production cuts could be expected if prices appear to be headed significantly below $60. The big question for both energy and industrial metals is the extent to which a slowdown in US growth will cause a significant slowdown in Asian manufacturing, given that roughly half of total industrial production from China and other Asian markets comprise exports destined for US markets. Mild weather from El Nino may also exert downward pressure on oil and natural gas.

For the past several years real estate investment, notably through the liquid REITs market, has been one of the most effective portfolio contributors both from a diversification standpoint, with R-squared levels typically less than 0.50 versus the S&P 500, while also offering superior returns. Taking a longer historical view, this asset class as represented by the Dow Jones REIT

(Full Cap) Index has only returned a negative performance twice since 1978: in 1990 and 1998, and over this period (January 1978 – December 2006) the REITs index returned an annual average 15.29% versus 13.21% for the S&P 500. Having said that, REITs outdid themselves in 2006, finishing the year up over 35%, and given that we expect to see a general softness in property markets this year we are generally not increasing exposure in 2007.

Hedge funds as an asset class are much talked about at cocktail parties but not very well understood. There are typically 5-6 primary hedge fund strategies including long-short, event-driven, global macro and relative value, and while at the individual fund level they have widely different strategies and operating techniques in the composite aggregate they tend to offer a combination of low volatility, low correlation with other asset classes and consistently higher than average returns. Obtaining exposure to hedge funds has historically been the province of very high net worth investors, and expenses are high relative to other investment vehicles, but as is typical for the financial services industry the product cycle moves quickly and there are now several efficient ways to take on hedge fund exposure in a manner consistent with the standards of prudence for different types of investor.

In fact, as hedge funds have started to move down the product curve into larger markets the new "must be in" vogue for the megawealthy is private equity. There is really nothing new about this asset class, which encompasses everything from early stage and venture capital through to leveraged buyouts and anything in between. Private equity has the benefit of being uncorrelated – in fact the notion of a "return" at all is fairly specious given the lack of liquidity in most private equity structures. As with the hedge funds space there are fund of fund structures and other ways of gaining exposure – or, with at least $50 million or so in backing and a particular target market one could create one's own private equity fund. Although much of the focus is currently on megadeals from groups like Carlyle, Blackstone and Apollo we also see potential value to private equity as a way to enhance global exposure and be in position to capitalize on the growth of global capitalization.

Structured products are not an asset class *per se* but rather a risk management tool to help us obtain a more refined risk position in any given asset class. Structured products can be a cost-effective way to target a range of desired outcomes including principal protection, caps, floors and outcome-weighted returns. We will be increasing our use of this innovation as a way to anchor our portfolio positions in light of uncertain market outcomes.

Conclusions

Well, if you have made it far enough through this document to reach the conclusions section you are probably thinking "oh no, what else can these people say to put a damper on the day?" That is certainly not our intention, and just to re-iterate the point, we do not think that our perfect-storm worst case scenario is the one that is most likely to play out in 2007. So that being the case you may wonder why we spent so much time elaborating on our reasoning behind the negative-outcome possibilities. Quite simply, we do believe that some "market tectonics" are currently playing out that will have a profound effect on the shape of investment markets during the time horizons of most of our clients. By no means are all of the tectonic plates negative. In fact, our appraisal of the international investment marketplace and particularly the development of emerging and transitional economic markets is that the opportunity may exist to achieve real, sustainable excess returns over a mid to long time horizon through a carefully developed and executed strategy. Tectonic plate collisions can certainly be disruptive, but with crisis comes opportunity, and that makes for an exciting time to be in this business.

On the other hand we realize that opportunity and volatility also go hand in hand, and you have to wonder – when you look back on several years in which volatility for the S&P 500 and Russell 1000 Value Index was not much higher than that for investment grade bonds – whether people have comfortably fallen asleep at the wheel only to be rudely awakened when those plates collide. Well, we are not asleep at the wheel and we are not taking anything for granted. Our sole mission is to see our clients win no matter which tectonic plates collide or if none collide at all. We do believe that 2007 is going to be a year when staying awake, alert and on watch for how fast the rapids are moving around that next bend will be of critical importance. If it turns out that we have been overly defensive – well, sometimes that is much better than being caught outside exposed when the storm blows in.

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