January 2008

The Year Ahead 2008

MVCM Annual Market Outlook

Executive Summary

Bad Moon Rising

Volatility returned to world asset markets in 2007 in a major way. The S&P 500 finished the year with a total return of **5.49%** and risk (measured by standard deviation) of **9.66%**. By comparison in 2006 the S&P 500 returned **15.79%** with a bond-like risk level of **5.64%**. Neither 2006 nor 2007 bear much resemblance to historical performance trends: for the period 1979 – 2007 the annual average return of the S&P 500 was **13.18%** with standard deviation of **14.69%**. As 2008 gets underway we see volatility continuing to be the contextual backdrop for a year potentially fraught with economic and political uncertainty.

Some years are good ones in which to outperform on a relative basis, while in others the primary goal is simply to make, not lose money. After all, outperformance doesn't amount to much if it means "lost less money than the index". While we do not necessarily think negative performance is the highest probability outcome for 2008 we think the risks are strongly oriented towards the downside. Our portfolios reflect a defensive bias against what we see as the major potential threats this year. In the following pages we discuss these in detail.

- The US economy is edging close to recession territory and may turn negative for at least part of the year. The Wall Street Journal's consensus estimate from 52 leading economists is for 2.0% real GDP growth for the full year but that same consensus sees a 42% chance of recession. We also think that below-trend but positive growth is the highest-probability outcome but see considerable volatility underlying that estimate, the main source of which volatility is US consumer spending.

- That greater volatility is skewed to the downside as a sharp drop in consumer spending – which accounts for over 70% of US GDP – is more likely than an upside surprise. Global inflation has also been ticking up in recent months and that raises the possibility of stagflation, that 1970s-era combination of anemic growth and high inflation. Higher prices are clearly hitting consumers where it hurts them most – at the gas pump, the grocery check-out aisle and the doctor's waiting room.

- The twin beasts of credit market meltdown and housing market plunge cast a long shadow over the second half of 2007 and continue to stalk the landscape in the early weeks of this year. Bargain hunters are scarce and it could be some time before longer-term trends reassert themselves, with a reasonable possibility for further declines.

- 2008 is an election year in a number of hotspots including Russia and Pakistan – and oh, of course we have something here in the US as well. We don't see much of a correlation between US market performance and the victory of any particular party or candidate – but election years create their own odd dynamics and the potential for ill-advised government policies coming out of ham-handed attempts to secure political positioning.

- The US equity market is having a terrible decade. Historical comparisons and current valuation levels argue for an uptrend, but fundamental economic realities don't paint as clear a picture. We think the likelihood is better than not that the broader US markets will not end the year in the red – but the real story this year is not expected return but the *magnitude of deviation* from expectations – which we think is very high.

- Our views on style performance among US equity asset classes focus on the importance of capitalization relative to valuation: in other words, we think the most critical style decision to make this year is increased weighting among high-quality large and mega-cap names while we maintain a relatively neutral view on value versus growth.

- In international equity markets the two main stories have been currency-driven outperformance by countries with free-floating currencies and the long, profitable run of emerged/emerging markets. The fundamentals don't look much different today than a year ago – the dollar remains in a relative position of weakness and the secular 3-5 year outlook for emerging markets is robust – but in 2008 we could see a mini-cycle of reversal to the longer-term trend.

- Fixed income markets reflect ongoing instability in the credit markets as the past year's Summer of Subprime continues to cast its shadow. Quality spreads continue to widen though not as dramatically as was the case several months ago. The benefits of interest rate cuts will not fall anywhere near to equally across the different sectors of the credit markets. In our view flight to quality will be the central theme this year.

- We have increased our exposure to alternative asset classes for low correlation benefits that we believe are of particular importance this year, with a favorable view towards commodities among high volatility alternatives and equity market neutral as a viable low volatility strategy.

The Economy

The "dismal science" threw up a mix of contradictions in 2007. Don't look for much more clarity in 2008 as the housing downturn, credit market woes, consumer spending, unemployment and global inflation play out across the world's developed, emerged and emerging economies. Plus, it's an unusually unclear US Presidential election year rich with the possibility of ham-handed government intervention in ill-advised ways to score political points.

Summary

In one way 2007 was quite similar to 2006: macroeconomic data confused more than enlightened. In the middle of 2006 the stock market shrugged and declared itself ready for a party, but a year later that party fizzled out as the phrase "Goldilocks Economy" dropped out of the lexicon to be replaced by "Subprime Mess". No discussion of the economy in 2007 is complete without mention of subprime loans and the sharp decline in the housing market – and often these two things are erroneously conflated. In fact they are two different stories – related, yes, but different.

An Economy of X-Factors

An X-factor is an unknown variable – an uncertainty that has the potential to actualize into a real, clear and present force. At the beginning of 2007 we noted that the alphabet soup of Wall Street credit derivatives – CDOs (collateralized debt obligations), CDSs (credit default swaps) and the other synthetic creations deriving their value from the cash flows of underlying assets like subprime mortgages, auto loans and credit card receivables – was an X-factor waiting to materialize. Materialize it did, becoming a clear and present reality by the summer of '07 with first Bear Stearns and then pretty much every other global financial behemoth disclosing their woes in ever more alarming dribbles of press releases.

At the same time this sorry tale was making its way through the chat shows and squawk boxes a steady stream of reports was driving home just how much the housing market had turned down. This made for some confusing media coverage. "Existing home sales plunged amid the unfolding crisis in subprime loans" intoned the news anchors, as if these two stories were somehow one and the same. They were not. Subprime loans were certainly a part of the housing market's downturn. But the subprime loan *crisis* – the mess that caused such gyrations in the stock and bond markets in July and August – was made by Wall Street bankers who took each dollar of irresponsible lending and borrowing and through their leveraging magic turned that *one* dollar into *four* dollars of irresponsible credit derivative securities.

The fundamental story in the broader housing market is that prices on existing single family homes fell on average by 3.3% from $217,300 to $210,200 during the period November 2006 – November 2007, but even that lower figure represents an increase of 146.1% from the median price of $85,400 on December 31, 1987. In other words the "historic" declines in asset values came on the heels of a commensurately "historic" multi-year growth trend. Real estate values are certainly not immune from mean reversion and the laws of gravity.

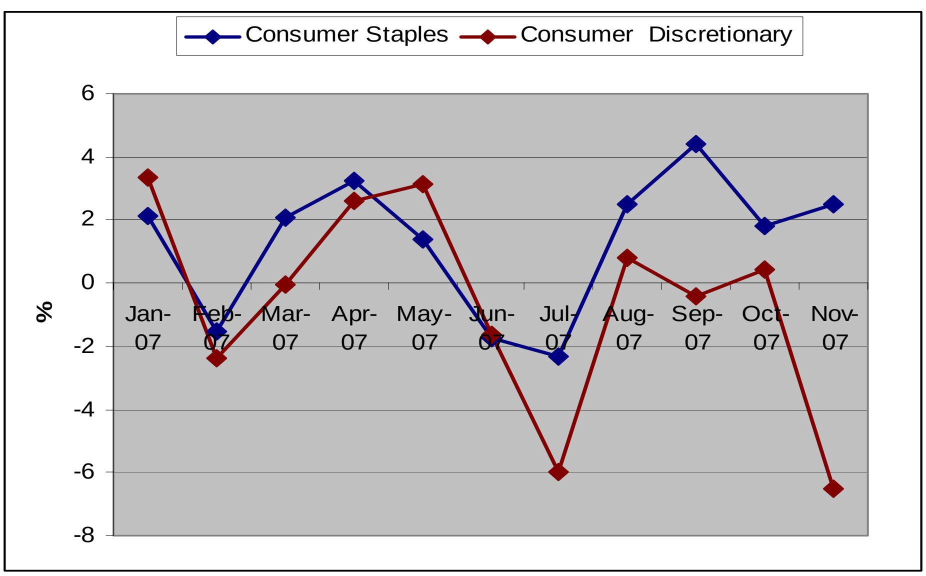
But the run-up in housing prices over the past twenty years has not been accompanied by a like run-up in household income. Household income has been essentially flat over this time, while the household savings rate has turned negative and consumer debt grew in 2007 to 133% of disposable household income.

Whither the Consumer?

Household income, savings, debt, and asset values (mainly home equity) are the four prongs of consumer spending, which in turn accounts for over 72% of total US GDP. Debt is up, savings are negative, income is flat and asset values are decreasing. Those are the facts. The anecdotal evidence casts an even gloomier pall – families are worried about job security, the skyrocketing cost of education, the decline or loss of retirement, health and other benefits. In recent weeks a growing number of polls show the economy as having become the number one issue among voters in the upcoming US presidential elections, displacing the war in Iraq.

And yet consumers appear to continue spending at reasonably healthy levels...or are they? Consumer durable and nondurable retail sales for November 2007 were up 1.2% year-on-year, double what analysts had expected. The determined hordes still showed up to Best Buy and Wal-Mart on Thanksgiving night motivated by, well, whatever would motivate a person to camp out in the cold until the doors opened at 5.00 am for Black Friday. But in December retail sales decreased 0.4%. The question is not really *whether* consumers are still spending – they are. It's *what* they are buying and *how* they are making their budget decisions.

The chart below gives us a clue. It shows the performance of the S&P/Citigroup Consumer Staples BMI (Broad Market Index) and the same measure for Consumer Discretionary. Staples are things we will buy no matter what, like soap and vegetable oil, while discretionary purchases include things like dinners out at the local Northern Thai restaurant and Italian terracotta bathroom tiles.



Source: Zephyr & Associates LLC

The message here seems to be: fewer terracotta tiles, more Crisco. That's the same message delivered by the Conference Board's December reading of the Consumer Confidence Index, which plunged to 88.5 after being above 100 for most of the past two years. Household budgets are tighter. The producer price index (PPI), a wholesale measure of inflation, was up 6.3% for

2007, the highest level since 1981. Most of the increase was due to energy and food. The Federal Reserve determinedly focuses on "core inflation" – i.e. everything minus energy and food – and it may come as a surprise to them that for most Americans the cost of gas and groceries really does matter to their weekly spending decisions.

Global Growth

US GDP growth in 2008 depends on the consumer, which in turn depends on how these X-factors in housing, the credit markets and elsewhere play out. The Wall Street Journal's pool of 52 economists, representing a variety of independent analysts, economic consulting firms and diversified financial institutions, show a range of real US 2008 GDP forecasts from 0.5% to 4.2% with the highest frequency occurring between 1.9% and 2.5%. That would put the US squarely in the middle of the outlook for developed economies around the world. Below is a table showing actual 2006 and 2007-2008 forecasted growth (Deutsche Bank forecast) for different countries.

Real GDP Growth, %	2006A	2007F	2008F
US	2.9	2.2	2.2
Canada	2.8	2.6	2.3
Euroland	2.9	2.6	1.6
Japan	2.4	1.6	1.2
Brazil	3.8	5.3	4.6
Russia	6.7	7.5	7.4
India	9.7	9.0	8.2
China	11.0	11.5	10.4
Romania	7.7	5.7	4.2
Turkey	6.1	5.0	5.5
Vietnam	8.2	8.3	7.5
World	**5.4**	**5.2**	**4.6**

Source: National Statistical Authorities; Deutsche Bank research forecasts

We have color-coded this table to tell three stories: the developed economies of North America, Western Europe and Japan; the "emerged" and increasingly influential BRIC economies of Brazil, Russia, India and China; and up-and-coming emerging markets like Romania, Turkey and Vietnam. It is very clear from this chart where the experts see the growth story continuing – that the developing world will help the world economy maintain its overall robust trajectory.

What is not so clear, though, is when and to what extent the closely correlated world of the *globalization* era will give way to the regional fragmentation of *global capitalization*. Global capitalization, or economic decoupling, will result in distinct performance patterns for consumer, manufacturing, service and capital markets in different regions of the world. The age of globalization is not completely over yet, however, and what the US consumer does or does not do in 2008 will certainly have a pronounced effect on what manufacturing plants in China and database research consultants in India post as revenues and profits this year.

The question to ponder is: what happens to that 10.4% GDP estimate for China in the table above if US growth is closer to 0% than to 2% or negative, particularly as any worse than expected performance in the US is likely to be driven by weaker consumer spending – on products manufactured in China and elsewhere.

Consensus numbers can provide a misleading comfort. They represent a statistically derived average, or mean, expectation. But in statistics the mean is simply the first measure of central tendency. The second is variance, a mathematical representation of the amount by which the actual outcome in any given period varies from the mean. The higher the variance the higher the resulting probability that the actual outcome will be quite a bit different from the statistical expected outcome. That risk is compounded when the likely range of outcomes is skewed in one direction or another rather than the familiar symmetrical Bell curve distribution. We are in such an environment now. Volatility (variance) is higher and the expectational bias is skewed to the downside.

US Equities - Broad Market Commentary

US equities are on track for the worst calendar decade performance since the 1930s. The market is not expensive at current valuation levels, but the bull market that started in 1982 may have already ended.

Markets don't have a calendar mentality, but people do. We govern our lives by the rhythms of the months and the seasons. So it is intuitively easier for us to contemplate what the markets did in 2007, or 2002, or during the 1990s. We tend to tune out when the market experts talk about "year-on-year" or "twelve month rolling windows" or other jargon for measuring returns on a more continual basis. We like to know where the market closed on December 31, where it opened January 2 and where it closed again next December 31. We are calendar-centric folks.

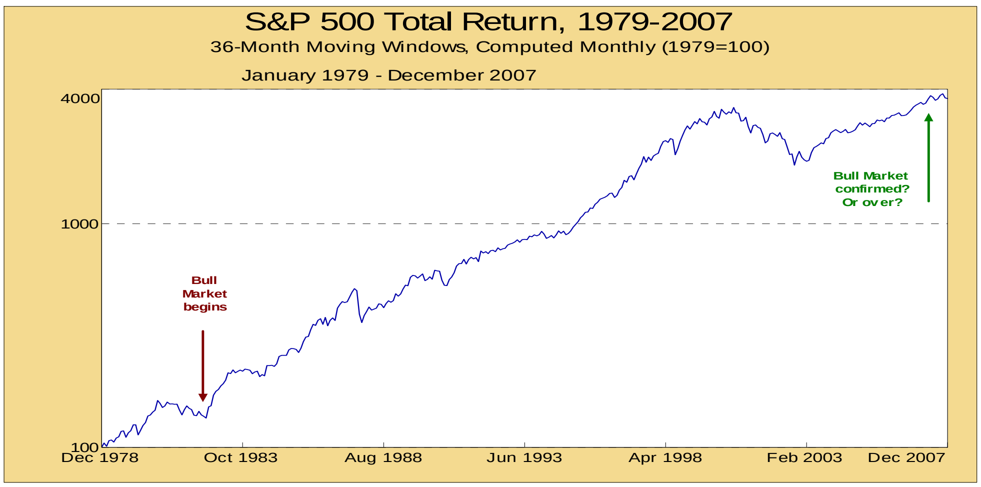
This decade is shaping up to be one calendar period that for many investors cannot end soon enough. Perhaps it is a good thing that "00s" doesn't role so easily off the tongue as "90s" and "80s", those two decades which between them had only two years of negative performance by the S&P 500, in 1981 and 1990. In this decade – the inelegant '00s – we have already had three years of negative performance with two years left to go before the clock runs out. The S&P 500 returned an annual average 17.53% over the 1980s and 18.21% over the 1990s. For this decade to the end of 2007 the annual average return was 1.66%. Bear in mind that the annual dividend yield – a component of the total return – is somewhere around 1.8%. *That means that the most widely used benchmark for the US stock market has shown no capital appreciation at all for this decade to date*.

Taking the calendar fixation just a bit further – most of us (well, those of us who were around at the time, anyway) remember the 1970s as the decade of stagflation, high interest rates and wardrobe choices that would haunt our family photo albums for years to come. Well, the total annual average return for the S&P 500 over that dubious decade was 6.7%. For us simply to beat the 1970s – a rather low bar in the history of US equities – the S&P 500 would have to do better than a 25% total return for *each of the next two years*.

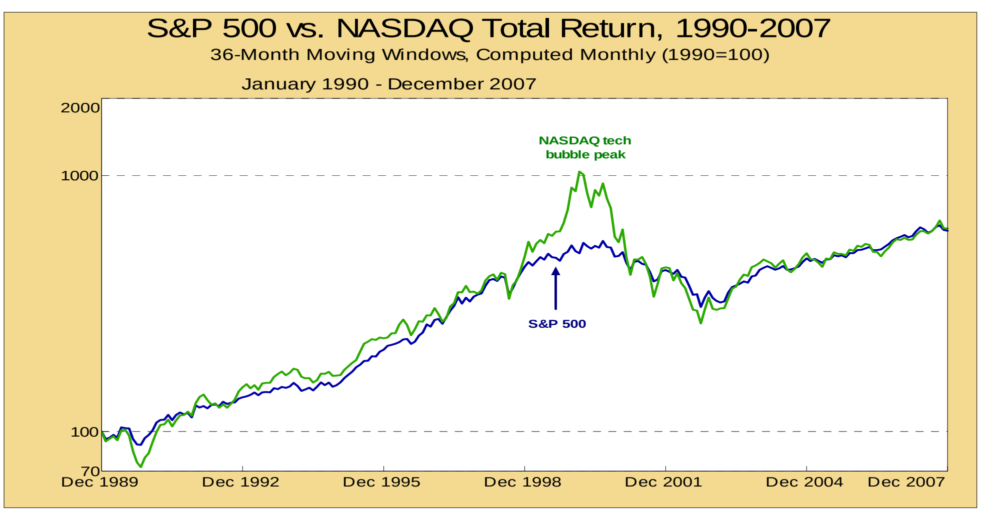
Could it happen? Sure – but what is the likelihood? Well, the market today is not expensive by historical standards. The price-earnings (P/E) ratio for the S&P 500 as of January 10, 2008 is 16.24x based on 2007 operating earnings. By comparison at the bottom of the most recent bear market on October 9, 2002, the twelve month trailing P/E was 25.3x. At the top of the previous bull run on March 24, 2000 the ratio was 30.9x and on December 31, 1996, on the eve of the late 1990s surge, it was 19.2x. To put all those numbers into perspective the market as measured by the P/E ratio is more attractively priced today than it has been for most of the past ten years.

So why aren't smart investors pouring into the market now like so many Filene's Basement bargain seekers? A clue lies in the "E" of P/E – earnings. Average year-on-year earnings for companies in the S&P 500 rose by double digits for 14 straight quarters from 2003 through 2006. The consensus among analysts for the 4th quarter of 2007 is for earnings in the mid-single digits, and a growing number of observers believe the outlook for 2008 is potentially weaker than that in the face of inflationary risks and a consumer spending slowdown. When earnings go down, all else being equal, the P/E goes up and the market suddenly doesn't look as cheap.

However there is a larger question behind this. The chart below shows the total return performance of the S&P 500 for the last 28 years, from 1979 to 2007. Nearly all of this period has been characterized by the technical definition of a bull market: where each previous market high is confirmed and surpassed. The closing high set of 1527 set on March 24, 2000 was surpassed on May 30, 2007 when the market closed at 1530. Bull market confirmed?



Technically, yes. But there is a case to make that the bull market which has defined the entire professional experience of many practicing analysts and portfolio managers is over.



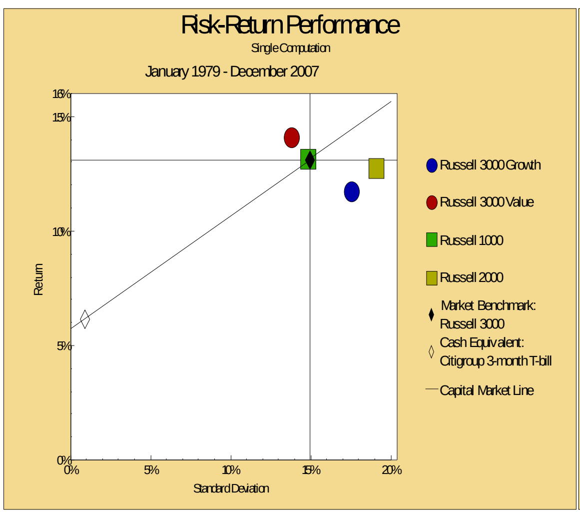
Source: Zephyr & Associates LLC

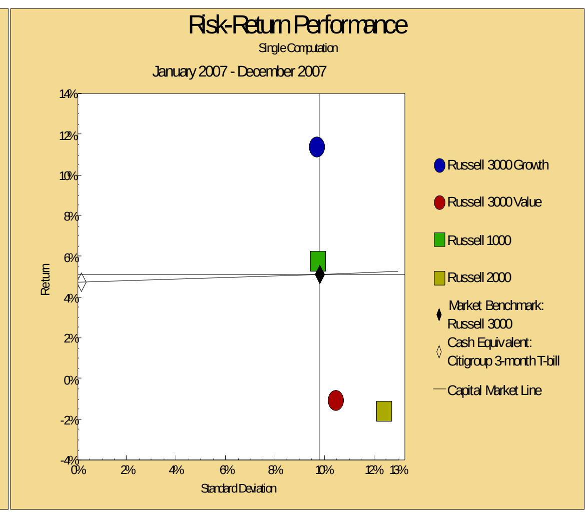
For one thing there is that nagging fact that the bull market confirmation is not shared by all major broad market indices – in particular the NASDAQ index as shown in the above chart. Anyone who put his or her money into the NASDAQ at the height of the tech bubble mania is still a long, long way away from breaking even. But in a more general sense there is a feeling of unease that the foundations on which the longest ongoing bull market since the beginning of the 20th century may be soft, and that in hindsight people will look back and conclude that, in spirit if not in the true technical sense, the 1982 bull market came to an end at the beginning of the '00s. And in any event the market today is more than 10% off last year's high point.

Of course we are not crystal ball readers and do not make any claims to speak for future historians. But as fiduciaries of our clients' money and trust we have to be prepared for any eventuality, and in the current environment that means caution, prudent diversification and a focus on the preservation of capital. In the following sections of this report we provide our views on different asset classes that are shaping our portfolio construction decisions for 2008.

US Equities - Style Commentary

So how are we to succeed in this dismal decade? When it comes to domestic equities the two style characteristics that matter most are capitalization (from mega to micro) and valuation (from deep value to go-go growth). This year we think the real story is in capitalization. The value-growth differential, which as the rightmost chart below shows was a major factor in 2007, may be less important in 2008.





Source: Zephyr & Associates LLC

This chart provides a comparison of the long-term (1979-present) versus one year performance of growth versus value (Russell 3000 Growth and Russell 3000 Value) and large versus small cap (Russell 1000 and Russell 2000). Over the long term value has outperformed growth on both an absolute and risk-adjusted basis while large caps have been safer and a bit better performing than small caps. Last year growth was clearly the place to be and small caps took a sharp tumble after outperforming large caps for six of the previous seven years.

Value and Growth

What happened in value versus growth last year was less like a cyclical reversion, and more an anomaly year like 1999. In that year growth strongly outperformed value on account of the dramatic outperformance of the technology and telecom sectors that weigh heavily in the growth indices. Last year growth strongly outperformed value on account of the dramatic *underperformance* of the financial sector that weighs heavily on the value indices. The brunt of the subprime lending debacle fell, quite naturally, on the financial institutions that had packaged up the loans and put them into those alphabet soup acronyms in the first place – Citigroup, Merrill Lynch, Bear Stearns et al, as well as the institutions that found those subprime borrowers in the first place like New Century and Countrywide.

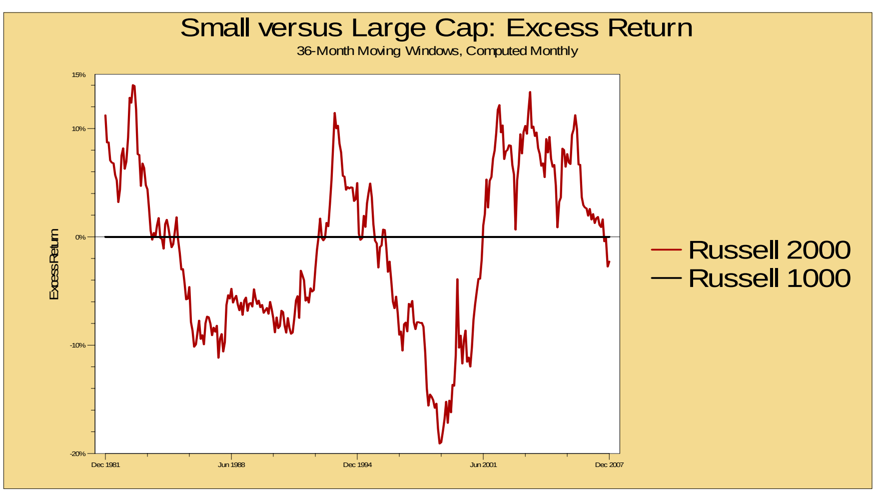
Looking at 2008 we see two possible outcomes. One is that financials get the worst of their predicaments behind them and investors come in for some bargain hunting. Given the importance of the financial sector, that would set an overall positive tone for the market. Indeed we think *a sustained rally in US stocks this year won't happen without the financial sector*. If this happens then value stocks overall could do relatively well. However, if financial stocks fail to rally in the headwinds of more bad loan disclosures and continued weakness in lending markets does that mean that growth will strongly outperform value again? We think not, for two reasons.

First, even if financials continue to underperform it is less likely that they would do so in the same double-digit territory as in 2007. The Fed and the European Central Bank continue to inject liquidity into the credit markets any way they can, and the likelihood of an outright financial collapse, while possible, is rather remote. Second, growth stocks by definition are susceptible to weak conditions in the overall economy. It is a bit of a stretch to make the case that, on the one hand the US economy and consumer spending measures are slowing and, on the other, that the main beneficiaries of this slowdown will be those companies most dependent on strong growth and spending!

To put it succinctly: the market needs the financial sector in order to rally. If the rally happens then value will be a good place to be. If the rally doesn't materialize then we think it's six of one, half a dozen of the other in the value-growth debate.

Capitalization

Large caps are poised for what we believe may be a significant long-term rally. The chart below shows excess return for small caps, represented by the Russell 2000 Index, holding large caps (Russell 1000) constant over the full market cycle since 1979 (three year trailing windows).



Source: Zephyr & Associates LLC

Interestingly it has been large caps that outperformed in the two major extended rallies of this period, during the mid-1980s and again in the late 1990s. Counterintuitively, small caps have done relatively better in the more negative market climates of the early 1980s, early 1990s and first three years of this decade. However we think the small cap rally of the last 7 years has run its course and that the combination of very attractive P/E valuations for the largest, cash-rich enterprises and prevailing market volatility will work to the benefit of large caps in general and particularly the mega cap (Russell 200, Dow Jones Industrials) segment.

International Equities

International markets have strongly outperformed the US for several years. A closer look reveals that much of this performance comes from two places: strong currencies versus the US dollar in other developed markets and in Latin America; and the surge of organic growth in Asian emerged & emerging market. Both of these trends may be due for a reversal.

Consider the following: in 2007 the MSCI EAFE Index returned 11.68% in US dollar terms, compared to the 5.49% return for the S&P 500. However in local currency terms the EAFE return was a modest 3.97%. Underperformance relative to the US is mostly attributable to Japan, which returned yet another unimpressive performance with a -6.71% in local terms.

Consider the 2007 total returns for the following:

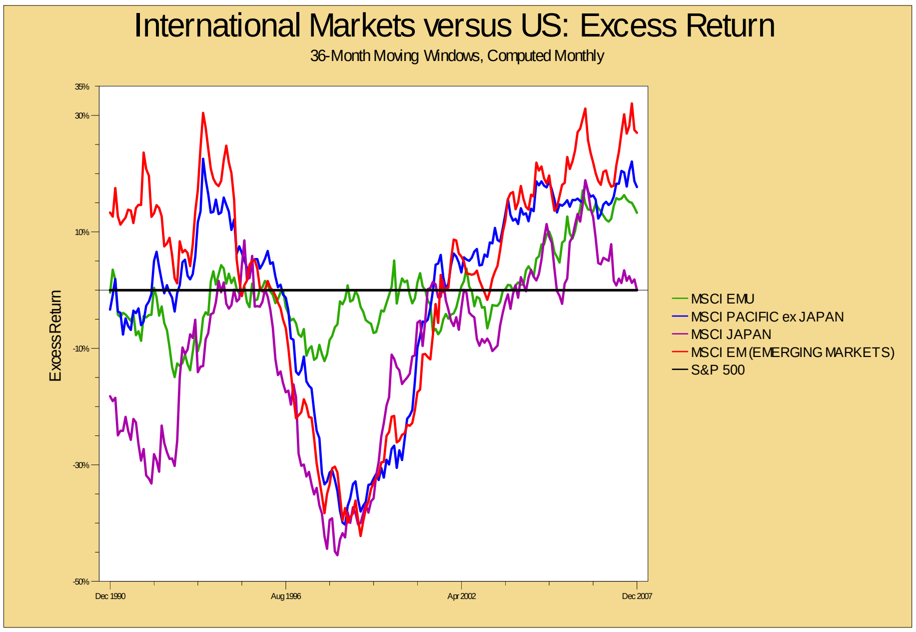
Index	**Local ccy**	**USD**	**Differential**
S&P 500	5.49%	5.49%	0.00%
EAFE	3.97%	11.68%	7.71%
EURO (Eurozone)	10.39%	22.39%	12.00%
Japan	-6.71%	-4.14%	2.57%
Pacific ex-Japan	21.61%	31.73%	10.12%
Emerging Markets	33.55%	39.78%	6.23%
EM Asia	39.11%	41.58%	2.47%
EM Latin America	35.58%	50.67%	17.09%
EM Eastern Europe	20.14%	25.98%	5.84%

Note: all indices from MSCI except for the S&P 500

The currency story dominated pretty much anywhere that the local currency floats freely against the US dollar, including the Eurozone, Australia, Canada, Brazil and Mexico. Where the local currency is either explicitly or indirectly managed against the dollar – encompassing most of Asia including that region's dominant economies of Japan and China – the performance difference attributable to currencies was more modest.

We are not in the business of predicting short-term moves in the currency markets – a fool's game if ever there was one. Over the longer term we think the outlook for the US currency is still weaker than stronger, but we think that most of the action going forward will not be in the dollar versus the Euro or UK pound or Australian dollar, but rather the effect of Asian monetary authorities loosening their currencies to trade more freely in order to remove growing imbalances in their monetary economies. There is no stated timetable for this – the "Bretton Woods II" status quo remains in place whereby Asian central banks build huge stockpiles of US dollar-denominated foreign reserves to fund US consumer spending and overseas defense adventures. Still, the trend is already underway if modestly - the Chinese yuan appreciated from RMB7.8 = USD1.0 to RMB7.4 = USD1.0 over the course of 2008, or a bit over 5%.

Currency trends aside it's worth noting that the US underperformed all major world regions except for Japan in 2007, a trend underscored by the chart below showing excess returns for EMU, Pacific ex-Japan, Japan and diversified emerging markets.



Source: Zephyr & Associates LLC

Of particular note is the strong run of emerging markets over the past five years. As we noted earlier in this paper we divide the so-called developing world into two categories: <u>emerged</u> markets, primarily the four BRIC countries along with other relatively well-off countries like Slovenia, Czech Republic, Malaysia and Taiwan, and <u>emerging</u> markets encompassing the remainder. The big story in recent years has been the global growth engine that is the BRIC countries and the growth spillover into smaller developing markets.

We firmly believe this growth will continue over our secular 3-5 year outlook and over this time period are optimistic about the prospects for emerged & emerging market equities. However we also believe that 2008 may be a correction year. At a P/E of 35.32 (as of January 11, 2008) the iShares FTSE Xinhua 25, a China-specific ETF, is quite a bit more expensive than the 20.65 P/E for IVV, the iShares ETF representing the S&P 500. The MSCI China Index was up 66.2% over 2007, a very strong performance indeed given that it came on the heels of a 82.9% return in 2006 and 20% return in 2005. China is a compelling story with the strongest growth outlook among major global economies. But anything that goes up also comes down, and in a year where US consumer habits threaten to cast a wet blanket on global growth China is likely to feel the effect. We think that same dynamic has the potential to play out across other emerging markets this year. Therefore we are *tactically cautious but strategically bullish on this asset class*.

Fixed Income

In 2007 the Lehman US Aggregate Index outperformed the S&P 500 for the fourth time so far this decade, with most of the strength coming from the highest quality sectors of the index.

As we noted earlier in this paper the S&P 500 has had a miserable decade to date by historical standards, and perhaps nothing underscores that as compellingly as the fact that the broader fixed income market (represented by the Lehman US Aggregate Index) has outperformed the stock market 50% of the time so far this decade. in 2007 the strongest performance came from the highest quality names in the mid-long part of the yield curve. The Lehman US Treasury 7-10 Year Index returned double digits at 10.19%. An even better performance, in contrast to 2006, came from US Treasury Inflation-Protected Securities (TIPS), at 11.63%. TIPS by definition should be expected to perform relatively well in inflationary environments, yet there is not a prevailing consensus that we are currently in such a period. However TIPS are also closely correlated with high real asset prices (such as energy, agriculture and precious metals) and a weak US dollar, both of which trends prevailed in 2007.

On the other side of the quality spectrum the Lehman US Corporate High Yield Index limped across the finish line with a 1.88% return. But it was not just the speculative names that found themselves in disfavor this year – performance for investment grade corporate bonds also lagged the safe haven government securities. The following chart shows how quality spreads in 2007 reversed the dominant trend of the previous four years:

Fixed Income Quality Spread Comparisons
As of December 2007

	2007	2006	2005	2004	2003
Lehman U.S. Treasury: 1-3 Year	7.30%	3.94%	1.65%	0.90%	1.89%
Lehman U.S. Treasury: 7-10 Year	10.19%	2.68%	2.42%	4.41%	1.86%
Lehman U.S. Corporate Investment Grade	4.56%	4.31%	1.67%	5.40%	8.24%
Lehman U.S. Corporate High Yield	1.88%	11.87%	2.74%	11.14%	28.96%

Source: Zephyr & Associates LLC

It is fairly easy to pinpoint when this reversal started. The trickle of information about failing special purpose investment vehicles (SPVs) linked to subprime loans turned into a deluge in August this past year, spreading from the riskiest sectors of the fixed income market to much more stable, liquid sectors like the multi-trillion dollar European commercial paper markets. During the critical days of August 15-16 many parts of the market essentially dried up – there were no bids and thus no valuation benchmarks. The Fed and the ECB stepped in with drastic liquidity measures and the Fed went on to initiate a set of aggressive rate cuts in the discount rate and the Fed funds target rate over August and September.

When interest rates go down bond prices go up – that is the mathematics of fixed income investments. In the wake of the central banks' actions prices did indeed go up for the high quality parts of the market – hence the stellar Treasury returns. Because prices for longer-dated issues react more to each basis point change in interest rates than shorter maturities (also one of the bond market's mathematical axioms) the result for longer-dated Treasuries was more pronounced than for the shorter end of the curve, as the chart above illustrates. But further down the quality curve yields changed very little at all or even increased as lenders stayed away from speculative issues.

Going forward the Fed badly wants to continue cutting rates. Board of Governors Chairman Bernanke gave a speech on January 10 that was perhaps the most aggressive in recent memory on this subject, signaling a view that slowing economic growth is the Fed's main concern. We expect the Fed will cut the Fed funds target rate by at least 50 basis points more over the first quarter of the year, which would bring the rate to 3.75%. That would likely continue the current trend favoring performance in the medium-long term part of the yield curve for the safest products like Treasuries and government agencies.

That may not be enough to keep the US out of recession however, and beyond the range of 50-75 basis points the Fed has limited means at its disposal to solve more fundamental economic problems through monetary policy. Inflation is still over the Fed's comfort zone of 1-2% for the core inflation measure (albeit not by much); oil remains stubbornly stuck above $90/bbl and the dollar is weak enough as it is at present interest rate levels.

We do not think the credit market troubles that surfaced in 2007 have by any means played out. The subprime mortgages of 2007 may give way to subprime auto loans and subprime credit card receivables, all of which are a major part of the asset backed credit derivatives market. This prompts us to approach our fixed income portfolios with caution. We essentially make two key decisions in fixed income: our core holdings of high quality government, agency, municipal and corporate names in short and intermediate durations; and our "plus" exposures from US high yield, global bonds and international emerged/emerging markets. In the core segment we will maintain a bias towards the safest havens in anticipation of a continued flight to quality, while our "plus" weightings will orient more towards global bonds and emerging markets, where we see less direct potential weakness from the current credit market environment than we do in US high yield.

Alternative Asset Classes

Among higher volatility alternative assets commodities continue to look better than real estate, while ongoing uncertainty in equity markets makes a case for more conservative hedge strategies like market neutral among lower volatility alternatives.

Alternative asset classes serve a primary function and a secondary function in investment portfolios. The primary function is diversification. Let's review for a moment why diversification is necessary: it reduces the likelihood of bad things happening to all the assets in a portfolio, at the same time and with the same magnitude. That's why we diversify.

Correlation Matrix

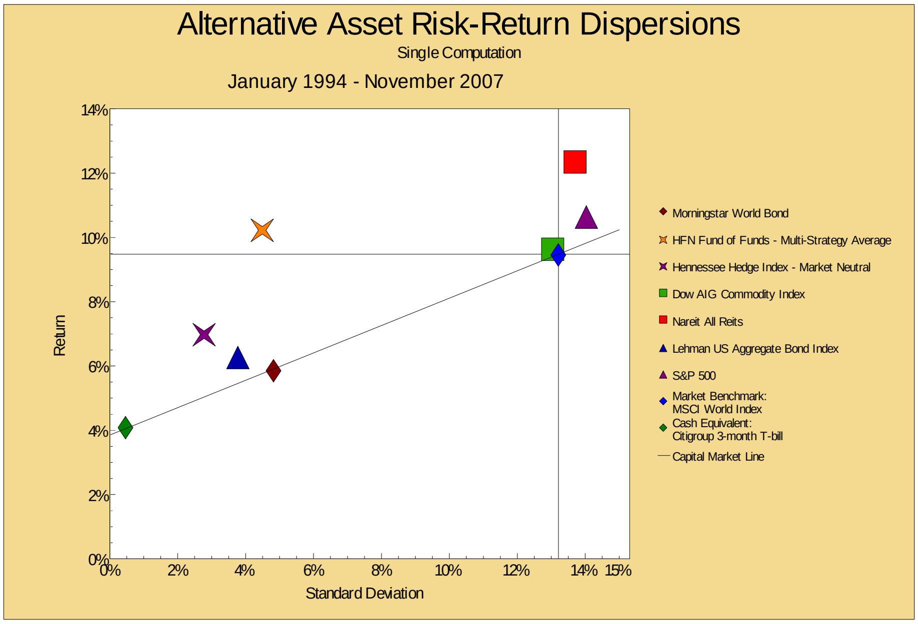
January 1994 - December 2007

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1) Morningstar World Bond	1.00							
2) HFN Fund of Funds - Multi-Strategy Average	0.27	1.00						
3) Hennessee Hedge Index - Market Neutral	0.14	0.34	1.00					
4) Dow AIG Commodity Index	0.26	0.32	0.06	1.00				
5) Nareit All Reits	0.25	0.25	0.13	0.10	1.00			
6) Lehman US Aggregate Bond Index	0.63	0.07	0.22	0.01	0.10	1.00		
7) S&P 500	0.20	0.48	0.06	0.11	0.34	0.02	1.00	
8) MSCI World Index	0.28	0.54	0.03	0.18	0.33	-0.05	0.94	1.00

The chart above shows the correlation – a statistical measure for diversification – among a handful of equity, fixed income and alternative asset classes. A measure of 1.0 indicates perfect correlation while -1.0 is the opposite. The low pairwise correlations seen in this chart between alternative asset classes and both equities and fixed income are the main reason for their being in our portfolios.

The second reason for having alternative assets is tactical performance. For example we like both commodities and real estate for their low correlation benefits, but some years (like this one) we prefer commodities based on expected returns and assign tactical weights to our portfolios accordingly.

The risk-return characteristics of alternative assets makes them seem more like equities or more like bonds, and for our portfolio construction purposes we group them accordingly. Commodities and real estate have equity-like high volatility properties while hedge strategies like market neutral, global macro and convertible arbitrage exhibit lower volatility characteristics more like bonds. The chart below illustrates this, with commodities, REITs and equities over on the right side of the chart and bonds, market neutral and multi-strategy (an amalgam of a handful of popular hedge strategies) on the left.



Commodities were the big story for 2007 as oil approached $100/bbl and gold reached levels not seen since the early 1980s. Although we think it more likely than not that oil prices will retreat somewhat over the course of the year we think that continuing upward pressure on agriculture and the potential for gold as a safe haven in the face of equity and currency uncertainty will keep a firm undertone to broad-based commodity indices. REITs had a terrible year in 2007, with the Nareit All-REIT Index falling nearly 18% as real estate markets across the country softened. REITs provide exposure primarily to commercial real estate markets, not residential, and stories of "ghost malls" and unfinished corporate development parks remind us that the commercial sector could prove to be worse even than the residential sector this year.

2008 may also be a good year for equity market neutral as a hedge against downside volatility in the equity markets. We look for beta-neutral strategies to serve as a cushion against our long exposures in US and international equities.

Conclusions

2008 is shaping up to be a very challenging, volatile year in the markets. Discipline, prudence and adherence to our core principles are never more important than when volatility reigns supreme and the performance outlook is uncertain. As we said at the beginning of this paper, outperformance is not impressive if it merely means "less negative than the market". Our goal is to make money for our clients in any market environment. Rest assured we will leave no stone unturned in doing our utmost to improve the probability of this being the case in 2008.

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