

Gresham Partners, LLC

Annual Outlook 2008

The second half of 2007 provided a stark example of the reasons we have felt that the risk/reward equation for investment markets was uninspiring. In particular, it confirmed and perhaps exceeded our expectations that credit markets would likely constitute Ground Zero in any financial upheaval. We can now say with much greater confidence that the problems in credit markets have spilled over into the general economy. However, we are fortunate that the credit crisis began at a time when global economic and business trends were relatively good, providing some cushion to the expected economic downturn. While the debate over whether the U.S. economy is headed for, or already in, a recession has become more of a technical exercise for economists, there is no debate that corporate profits, particularly those in the financial and consumer discretionary sectors, are slowing and general business conditions are weakening.

The outlook for global growth appears more positive, but not without caution. Earlier this year, we wrote about the desynchronization of global growth and the diminishing importance of the U.S. in the global economic landscape. This may be a blessing as strong growth abroad may provide the lifeline that shortens or lessens the U.S. downturn.

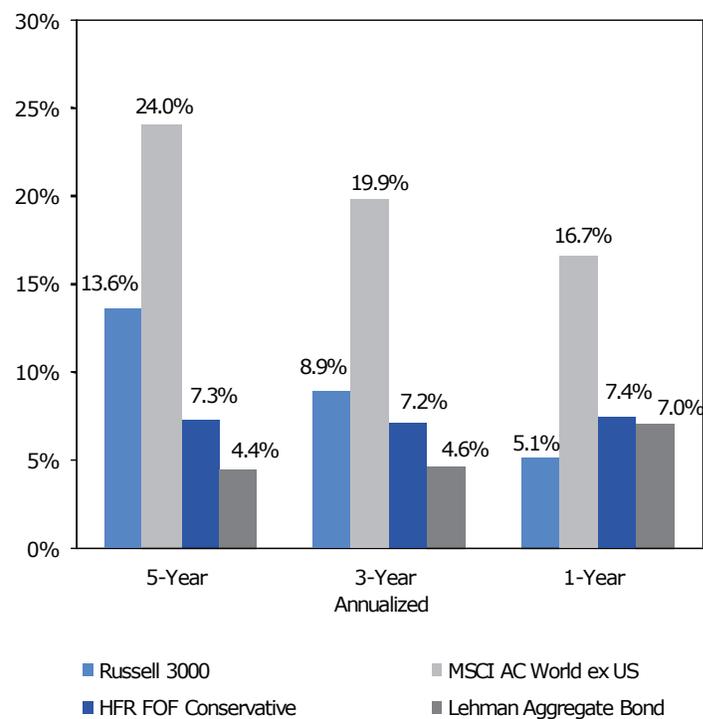
Market Review

Market volatility continued during the fourth quarter, reflecting investors' ongoing concerns about the financial sector and the increasing probability of a U.S. recession. Overall, U.S. stocks declined by nearly 3% during the quarter, leaving the market up a modest 6% for the year. Value-oriented stocks (-5.5%) continued to lag growth stocks (-0.2%), mirroring their overall performance for the year, as value stocks posted a modest decline while growth stocks increased over 12%. Small stocks continued to lag the overall market, resulting in negative returns (-0.6%) for the year.

The U.S. stock market continues to be marked by wide dispersion among sectors. The hardest hit sectors during the quarter were not surprisingly financials (-14.9%) and consumer discretionary (-9.8%). Driven by their fourth quarter performance, these two sectors were also the largest losers for the year, during which all other sectors increased at least 8% with energy (+36.1%), materials (+23.6%), and utilities (+20.4%) leading the way as they have for the last three and five years.

One of the weakest sectors was REITs, where the NAREIT index declined 11.5% for the quarter bringing year-to-date performance to (-17.4%). While REITs had been one of

Exhibit 1: Historical Performance



the strongest performing sectors over the last few years, returning over 30% in three of the last four years, three-year performance now trails the overall U.S. stock market.

Foreign stocks widened their lead over U.S. stocks during the last quarter and finished the year up 16%. However, eight percentage points of this outperformance was accounted for by the decline of the U.S. dollar. Foreign developed market stocks actually trailed U.S. stocks by a few percentage points in local currency. Emerging markets finished the year strong, returning 39.7% during the year. The laggard in the international markets continues to be Japan which declined 6.7% during the quarter, leaving the MSCI Japan index down 4.8% for the year despite benefiting from the Japanese yen's modest 4% appreciation relative to the dollar.

High quality taxable bonds benefited from a flight to safety and enjoyed a positive quarter, posting a solid 7% return for the year. High quality municipal bonds turned in a similar 5% return, but high yield bonds were down over 1% in the quarter as credit spreads widened due to growing investor concern about ongoing credit problems and the possibility of a recession.

Hedged strategies posted modest returns during the quarter and have now increased 7% for the year. However, for the

first time in several years, we witnessed wide dispersion among hedge funds, including several high profile failures during the summer.

We do not have comparable data to include in Exhibit 1 for non-marketable real estate and private equity markets. However, based on preliminary information, it appears that these categories performed well, due primarily to strong first-half appreciation. Real estate markets appear to have softened at the end of the year as more prudent lending standards re-emerged. Within private equity, several LBO deals were pulled due to lack of financing which will likely dim the overall performance of the industry in the coming year.

Overview

The second half of 2007 provides a stark example of the reasons we have felt that the risk/reward equation for investment markets was uninspiring. In particular, it confirmed and perhaps exceeded our expectations that credit markets would likely constitute Ground Zero in any financial upheaval. We can now say with much greater confidence that the problems in credit markets are not limited to subprime mortgages, as a similar disregard for risk and underlying credit fundamentals has affected other areas of credit markets, such as leveraged loans. Unfortunately, these difficulties have yet to run their course and may take a year or more to fully play out.

However, we are fortunate that the credit crisis began at a time when global economic and business trends were relatively good, providing some cushion to the expected economic downturn. The debate over whether the U.S. economy is headed for, or already in, a recession has become more of a technical exercise for economists. However, there is no debate that corporate profits, particularly those in the financial and consumer discretionary sectors, are slowing and general business conditions are weakening. The writedowns in the financial sector and the restoration of lending standards indicate that credit availability will be limited for some time, applying further downward pressure on economic growth.

General business conditions appear to be deteriorating. Quarterly profit growth for the U.S. financial sector is expected to decline 65% from a year ago, representing the largest such decline since the savings and loan crisis in early 1990s. In a broader context, overall earnings growth is now expected to decline over 10%, quite a reversal from the 10% growth estimated at the end of the third quarter. Should these declines occur, it would be the first back-

to-back quarters of negative earnings growth since the U.S. recession six years ago. Additionally, we are seeing indications that job growth is already beginning to slow. The problems of Wall Street appear to be spreading to Main Street.

The outlook for global growth appears more positive, but not without caution. Earlier this year, we wrote about the desynchronization of global growth and the diminishing importance of the U.S. in the global economic landscape. This may be a blessing as strong growth abroad may provide the lifeline that shortens or lessens the U.S. downturn. However, we are beginning to see signs that European and Asian growth are slowing and, while U.S. influence may have diminished, it is unlikely our trading partners will escape a U.S. slowdown unscathed.

In this context, let's examine the longer term, secular themes which dominate our view of the world and asset allocation strategies.

Inflation

As our clients know, we believe that inflation trends are a primary driver of future expectations for economic, business and investment trends. While there is little apparent danger at the moment given the slowing U.S. economy, an up-tick in inflation would likely damage bond and stock markets and might over time enhance returns from "real" assets, such as real estate.

In recent times, we have lived in two different worlds concerning inflation. Wage rates and the price of manufactured goods and most services have increased at modest rates, between 2% and 3% over the last three years. These items comprise what economists call the "core" rate of inflation. The prices of food and energy, two very important components of consumer prices, have grown at much higher rates and the question has been why the core rate of inflation has not risen more in the face of such a large increase in the price of food, energy and other commodities.

The reasons for this seeming dichotomy stem from the competitive effects of globalization, including the low cost of labor in many emerging countries, and the ongoing rationalization and restructuring in developed economies, including Europe and Japan. These forces restrain the ability of businesses to raise prices and of labor to demand higher wages. However, these secular trends may be slowing as we begin to see increasing unit labor costs and inflation in nations which historically exported deflation. For example, China's inflation rate has grown to 6.5%, up sharply from only 2.2% at the beginning of 2007. We expect the disinflationary benefits of globalization to continue, but at a decreasing pace.

The reaction of the U.S. Fed and other central banks to the recent credit crisis has been once again to inject liquidity into the financial system and lower interest rates. In the longer term, these actions are likely to promote a further round of asset inflation and, in the longer term, a return to the fears we saw earlier this year about an upturn in a general level of inflation and interest rates. The good news on the inflation front, is that a slowing U.S. economy will likely lead to slowing of wage pressure, possibly perpetuating our inflation dichotomy for sometime.

Reflation and Liquidity

The world has been awash in liquidity for a number of years and is likely to remain so. While the recent credit crisis has temporarily reined in investors' appetite for risk and the availability of near-term liquidity, funds available for investment around the globe remain substantial. The effect of the credit crisis, so long as it lasts, may be severe, but the willingness of central banks to inject liquidity in conjunction with available global investment reserves, may serve to reignite asset inflation when the current crisis has passed; a frustrating environment for risk conscious investors such as ourselves.

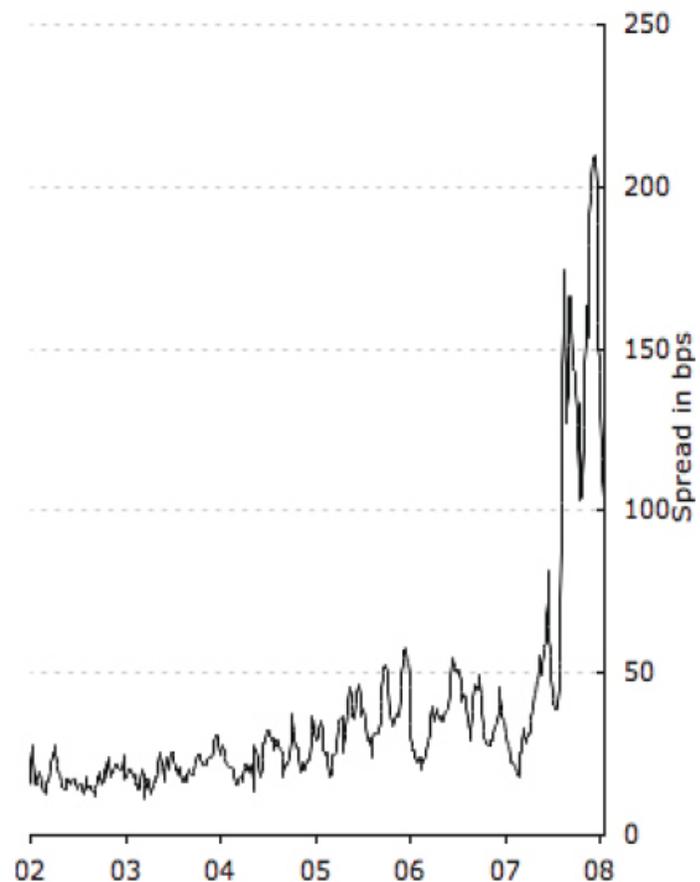
In the near-term, liquidity is a significant concern until confidence in the banking system is restored. One indicator the Fed uses to gauge this problem is the TED Spread. The TED Spread is calculated as the difference between T-bill rates and LIBOR and is used as indicator of credit market risk. Generally, when the market is in the midst of a crisis or liquidity crunch the TED Spread tends to widen. Exhibit 2 shows the dramatic widening that has occurred as a result of the current credit and liquidity crisis. The market is still indicating its belief that the ongoing trouble in the banking system will linger for the foreseeable future.

The Consequences of a Weaker Dollar

Today, it appears the Fed stands ready to lower interest rates in an attempt to minimize the consequences of our current credit crisis. The Fed's historical willingness to rescue capital markets has likely contributed to recent declines in the U.S. dollar. While we do not know the future direction of the dollar, anecdotally we now see equally as many economists who believe that dollar has further to fall as believe the dollar is undervalued relative to other developed currencies.

What we do know is that the U.S. dollar has fallen significantly over the last five years, which many attribute to a range of causes, including the U.S. current account and trade deficits or simply an unwinding of the strong U.S. dollar in the late 1990s. On this front, our primary concern for clients is to protect and grow the real purchasing power of their assets. As the world becomes an increasingly inter-

Exhibit 2: The TED Spread
3M Libor - 3M T-Bill (Weekly)



Source: Bloomberg

connected place, we must address purchasing power risk on a global basis. The U.S. dollar is a critical component of this equation, as declines in our home currency essentially erode the global purchasing power of our assets. We will address our current investment approach to this risk in our discussion of Foreign Stocks, however several real economic implications are worth reviewing in greater detail.

Growth Redistribution and the Trade Deficit

The foreign exchange market is a highly effective mechanism for redistributing growth around the globe. When the dollar was in a cyclical strengthening period from 1997 to 2002, the U.S. economy was a global economic engine (except in the dot com recession of 2001). However, dollar strength during this period created an export revival by foreign countries, which propelled our trade deficit to a record 7% of GDP by the end of 2005 as shown in Exhibit 3. Conversely, as the dollar reversed course over the last five years, we are

now beginning to see improvement in our trade balance as the current account deficit has receded to 5% of GDP and, ex-oil, it has reached a six-year low of only 3%.

Manufacturing Renaissance

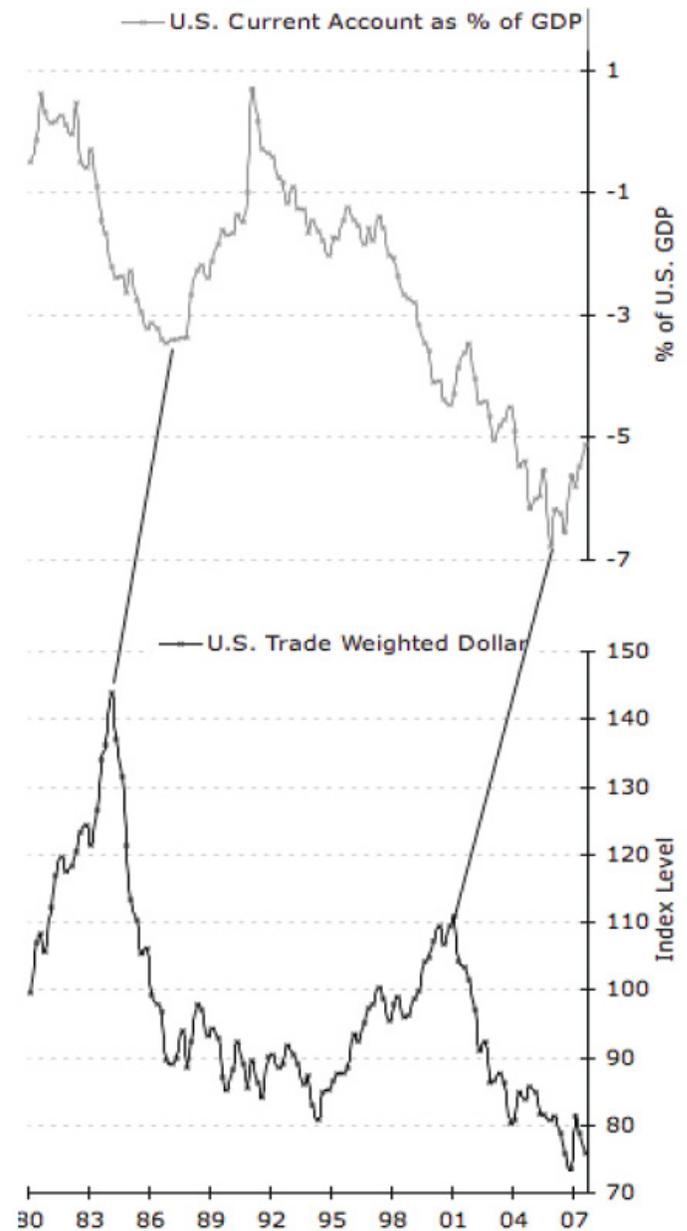
The declining dollar has boosted our competitiveness relative to major trading partners and is at the heart of what appears to be a nascent U.S. manufacturing renaissance. One economist estimated that U.S. unit labor costs in dollar terms relative to the rest of the industrialized world are the lowest they have been in the last 30 years. As further evidence of this revival, net foreign direct investment in the U.S. manufacturing sector rose 16% last year, compared with net outflows from five years ago, when a stronger dollar prohibited cost effective local manufacturing. Additionally, we are beginning to see import substitution as exports of manufactured products are up 12.4% over the last year while comparable imports have risen just 1.7%. This is a positive long-term development for the U.S. economy which needs to find a healthier GDP balance between the consumer, which currently accounts for a record 70% of GDP, and its U.S. manufacturing base.

Sovereign Wealth Funds and Foreign Investment

While a weakening U.S. economy is likely to slow domestic mergers and acquisition activity, we expect to see a resurgence of foreign acquisitions in the U.S. Many will remember the weakening dollar of the mid-1980s which led to a surge in acquisitions by foreign investors, most notably the Japanese. Today, we face similar circumstances where, after years of a weakening dollar, foreign investors can purchase American assets at a significant discount. As we have already seen, some U.S. trophy franchises may be particularly vulnerable.

Several foreign central banks are beginning to move away from traditional short-term investments and venture into riskier assets such as private equity and real estate by establishing and funding sovereign wealth funds ("SWFs"). At least six SWFs command in excess of \$100 billion, with Abu Dhabi's estimated to exceed \$600 billion. Entities like these have contributed to the growth in foreign acquisition, which now exceeds 20% of all U.S. acquisitions, up from only 12% two years ago. While we expect this activity to increase, some caution is warranted as it will likely give rise to a growing sense of nationalism and a renewed round of protectionist politics, similar to the 1980s with Japan. As we discussed earlier this year, these types of protectionist measures usually undermine economic growth and create additional inflationary pressures. When we combine the current state of excess global investment reserves with discounted values in the U.S., we believe the U.S. equity market is likely to be a bargain hunting ground rather than fall into a long-term secular decline.

Exhibit 3: U.S.: Trade Deficit is Narrowed by a Cheaper U.S. Dollar



Source: Bloomberg

Credit Concerns

Credit markets are proceeding through a slow moving crisis that will unfold over the next several years and likely present interesting investment opportunities in the near future. For example, the fallout from the subprime mortgage issues will not be fully known until rates are reset on many such mortgages, a process that will extend out through 2008. The leveraged loan market is just now being tested and a period of slowing economic growth should expose some of the more egregious lending practices in the private equity

boom of recent times. Such opportunities would most likely be accessed through distressed debt managers focusing on mid to small sized issuers.

The sub-prime crisis continues to ripple through the financial system. The magnitude of potential writedowns is significant, with some estimating losses yet to be realized exceeding \$200 billion. Some have compared the current crisis to the S&L debacle of the early 1990s. Both problems were rooted in real estate excesses and both appear to have been triggered to some degree by aggressive Fed tightening. While the final results are unknown, both appear to have driven the U.S. economy into or near recession. Interestingly, it appears their resolution may have some parallels as well. The S&L crisis was solved by aggressive Fed easing and the formation of the Resolution Trust Company to restore investor confidence and allow banks to rebuild their balance sheets. Today, the Fed is providing the same support, while the capital markets are reacting much faster than the U.S. government in the form of foreign investments and injections of capital to restore confidence and allow banks to rebuild their balance sheets.

While we do not appear to be heading toward a systemic shutdown of the financial system, confidence in the banking systems must be maintained to engage in an orderly rationalization through a likely economic slowdown. We are fortunate that this crisis comes at a time of significant global liquidity, where capital injections and rescue financings appear readily available to bolster the balance sheets of many financial institutions. However, the following factors might cause one to worry that the challenges faced by many financial institutions today may be larger than most realize:

- Some of the instruments owned by banks and hedge funds are quite illiquid and are difficult to understand and price. Pricing remains a significant issue as rumor has it that major players in the asset-backed world are today carrying a given instrument at significantly different values.
- Extraordinary growth in many derivative instruments presents uncertainty as these newer instruments are largely untried in an era of market turbulence. Moreover, the notional value of these derivative contracts far exceeds the outstanding supply of the underlying instruments, creating complete reliance on the financial strength of the counter-party for settlement and recovery; a prospect that is not as appealing as it was only a few months ago.
- While the amount of leverage of any given firm may appear acceptable, a great many more players have now

joined the game so that there may be more aggregate leverage in the system than ever before.

- Finally, and most troubling, it has become apparent that the capital ratios of financial institutions have been overstated given their off-balance-sheet liabilities, such as the much-publicized structured investment vehicles ("SIVs") of major banks. While these vehicles are off the balance sheet of major banks, the sponsoring bank often has obligations to these vehicles that spring to life when they cannot refinance their borrowings, as was recently the case.

The U.S.' Place in the World

Earlier this year, we wrote about the U.S.' diminishing importance in the world and the need to maintain our global search for investment opportunities. While the U.S. will remain the world's greatest economic and military power for the foreseeable future, the degree of its superiority appears to be in decline, as the preoccupation and expense of the Iraq War, a slowing economy and a falling dollar undercut its importance. The ascendancy of China and other emerging economies and their desire for a role in the world consistent with their greater economic significance, is likely to lead to redistribution of global economic, political and military power over time.

Once we move beyond our initial geo-centric trepidation, changes of this magnitude often create opportunities. What appears to be a decoupling of the world is in fact an entirely new reordering of economic influence which will provide a multi-polar, global economy that may be better balanced and less susceptible to deep and prolonged cycles. Relatedly, we are finding an increasingly greater number of investment opportunities in foreign markets given their relatively higher growth rates and the opportunities to exploit inefficiencies that lesser-developed and rapidly changing markets often present.

As just one example of the opportunities overseas, see Exhibit 4 on the rapid GDP growth of the BRIC economies as a percent of world GDP compared to the U.S.' share. It is the rise of the consumer class in the emerging countries that presents one of the largest investment opportunities around the globe.

Rising Correlations

The growth of liquidity available for investment and the disregard for risk prevalent in recent years has caused an unusual convergence in pricing and valuation across asset classes. One might say that market efficiency has come to asset allocation. This reduces the benefit of diversification across asset classes and increases the systematic risk of well-diversified portfolios. While periods of brief conver-

gence has always accompanied major liquidity events or market upheavals, future events may be significantly worse given in the future since the current degree of price convergence has never been experienced before. We are perhaps seeing these consequences in the current market turmoil as all asset classes appear to be struggling through a problem that is firmly rooted in the credit markets. Longer-term, we believe asset allocation will be a less useful tool for risk mitigation going forward and that implementation within asset classes and manager selection will be at a premium.

Institutionalization of Alternatives

Alternative investments are rapidly growing in popularity among the broader institutional market as many of them seek to become more "Yale-like." In the process, they are diminishing their investments in traditional assets, such as bonds and stocks, and increasing their investments in alternative strategies. The result is likely to produce a somewhat depressing effect on traditional assets, while inflating the value of alternative assets. In the long-run, this will likely diminish the benefits of alternative strategies for investors, but have the opposite effect on the firms that sponsor and manage these strategies.

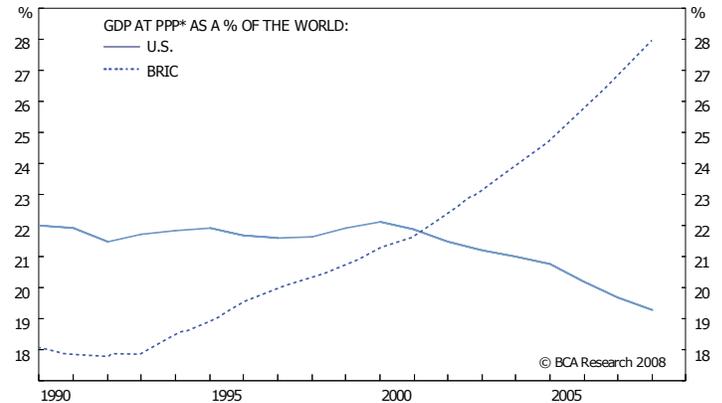
Given the relatively low percentage allocated to these strategies by most institutions, this is a long trend, likely structurally increasing valuations and, hence, lowering returns, to assets in these categories. In evaluating alternative strategies, we must focus not only on their fundamental value and usefulness in mitigating risk, but also on the long-term price support they are likely to receive from the structural flow of funds into such strategies.

Domestic Equities

While equity markets are likely to continue to experience increased volatility and some declines, we are fortunate to have entered this crisis when stock markets were not wildly overvalued as they often have been prior to bubbles bursting. In this case, the locus of excesses, as we have said for some time, was in the credit markets, not in the equity markets. During the second half of 2007, the market punished the financial and consumer discretionary sectors, appropriately reflecting ever more apparent problems within these sectors, while sparing (at least on a relative basis) the less affected areas of the economy.

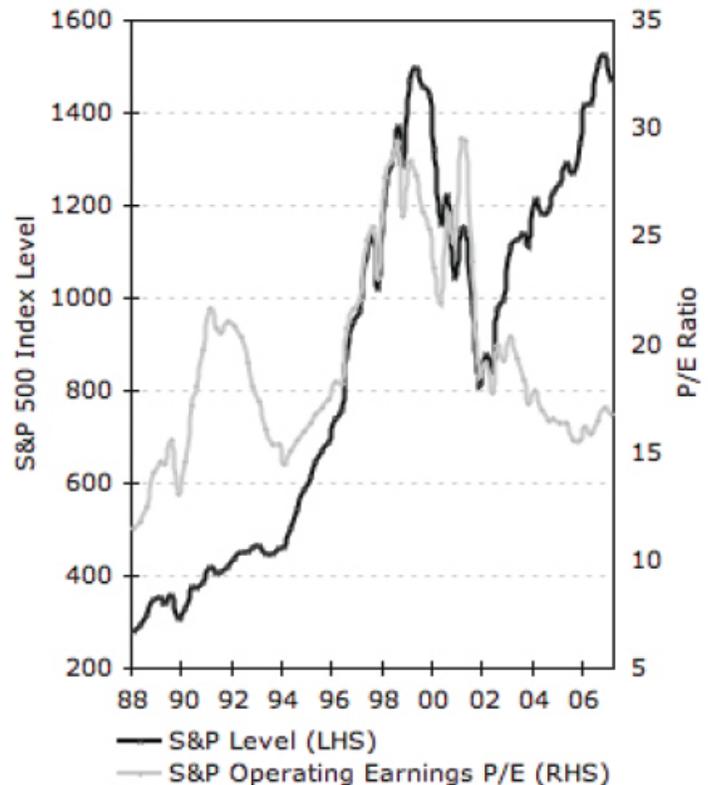
As we look forward, fourth quarter earnings are expected to come in down more than 10%, with financials leading the way with an estimated year-over-year fourth quarter decline of 65%. Surprisingly, bottoms-up estimates for the overall market for 2008 remain largely unchanged

Exhibit 4: BRIC Economies Share of Global GDP



Source: BCA Research (*Economist Intelligence Unit; Including Projections)

Exhibit 5: S&P P/E Ratios vs. Index Levels



Source: Standard and Poors

with corporate earnings expected to increase over 14%. This appears rather optimistic and largely incongruent given that many analysts believe earnings will continue to decline well into 2008. Uncertain earnings forecasts provide a shaky foundation for U.S. equity markets, which are likely to remain volatile until a clearer picture of profitability emerges.

The S&P 500 was trading at about 14.5x projected 2008 estimated (albeit likely inflated) operating earnings. The long-term average P/E ratio is about 15x, although these data mix reported and operating results. In recent years, when operating data were used, the forward average was closer to 12x.

In contrast to the 1994-2000 bull market, which was built primarily on multiple expansion, the recent bull market was built on earnings expansion. When this bull market began in 2002, operating P/E was just shy of 20x. Over the last few years, valuations have declined toward long-term averages despite the significant gains in the market as earnings accelerated at an even more rapid pace. Exhibit 5 illustrates the divergence of the P/E ratio of the S&P 500 and the Index itself. It is fair to say that the combination of increasing corporate earnings and more modest share price increases have improved the valuation of U.S. stocks. The near-term corporate earnings picture is still unsettled, but with estimated P/E ratios nearing their lowest point in a decade, the subject of fair valuation is a more balanced debate.

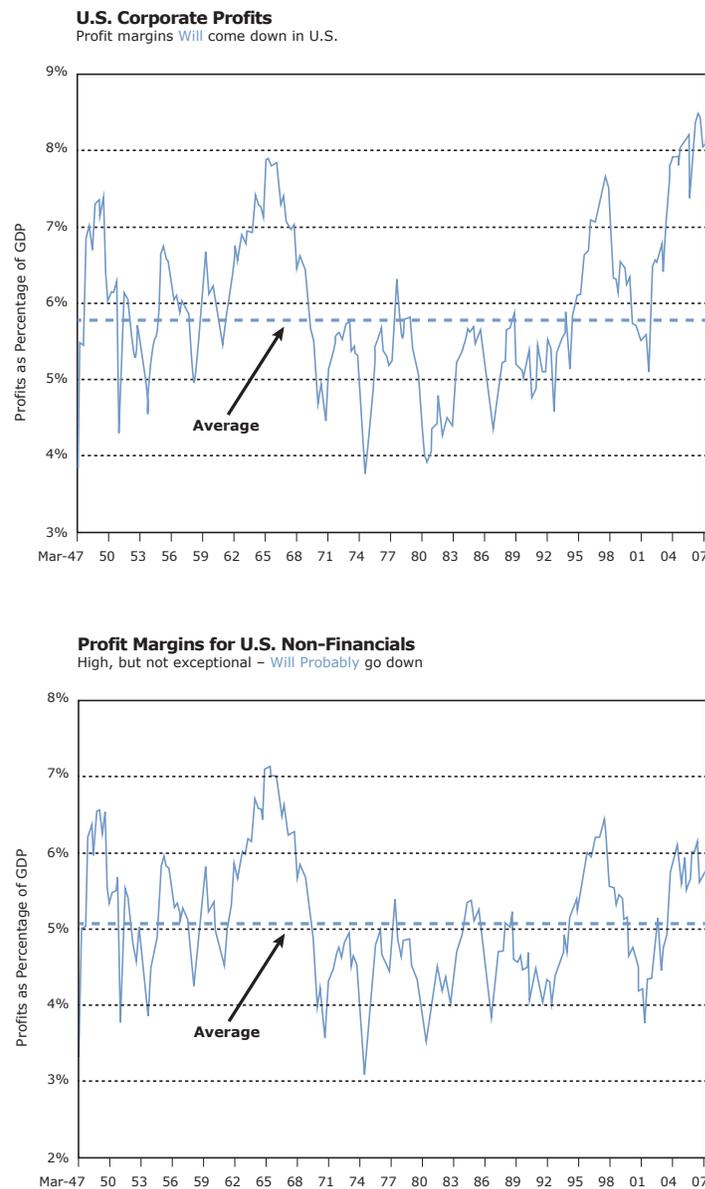
As always, we face two primary questions when attempting to answer the question of equity market valuation: what is a reasonable expectation for future corporate earnings and what multiple should be attached to those earnings.

Corporate Earnings

As we discussed earlier, corporate earnings will likely decline over the next few quarters as the economy retrenches to reflect the impact of the sub-prime mortgage crisis, write-offs in the financial sector and the systematic reduction of available financing. Our somewhat pessimistic outlook for corporate earnings is exacerbated by the following:

- Continued write-offs of sub-prime mortgage holdings as well as other asset-backed securities and structured notes.
- Share repurchase programs, which have boosted per share earnings over the last few years, will likely slow as financing available to support these programs is at least temporarily more difficult to obtain. Earlier this year, share repurchase programs were estimated to account for nearly half of all operating earnings growth.

Exhibit 6: Corporate Margins are Unsustainably High



Source: GMO

- Earnings growth forecasts have a strong tendency toward optimism. One of our managers has done a rather interesting study looking at the tendency of corporate management to overstate earnings and the tendency of analysts to be overly optimistic in their earnings forecasts by as much as 10% over recent years.
- On the corporate side, this same study indicated that operating earnings data, on which we and other market analysts focus our analysis of corporate earnings trends, regularly overstate corporate performance. This is apparent in the tendency of net earnings (which net out the

effect of extraordinary items, such as write offs) to lag operating earnings by a substantial amount, which was about 20% over the period 2002-2005.

- The combined effect of the overstatement by corporations and analysts could result in earnings estimates that are 30% overstated, meaning P/E multiples may be much higher than the market believes.

Operating Margins

For some time, we have noted that a key risk to corporate earnings growth is the historically high profit margins on which current earnings were based. We know that corporate profitability is one of the most reliably mean-reverting data series as excess profits will always attract capital, which tends to drive margins down. We also note that many analyst forecasts optimistically called for further profitability increases. We felt that a reversion to the mean is inevitable at some point and would reduce earnings estimates.

However, much of the record profit margins were generated by financial companies. Exhibit 6 shows the profit margins for financial and non-financial companies. While non-financial company margins are above average, they do not pose the same level of risk we noted in the overall market or financials services in particular. We now know that financial margins were unsustainable, not because of an influx of competing capital, but rather they were illusions based on flawed models and leverage. This problem appears to have been rectified, at least temporarily.

Equity Market Multiples

While earnings are not easy to predict, changes in stock market multiples are even more difficult to forecast as they depend so much on perception and psychology. The declines in U.S. market P/E ratios since 2002 is a good example. With U.S. stock market P/E ratios settling toward their historic norm, valuation provides no clear direction for equity markets.

- Risks to the upside for multiples rest on large liquidity reserves around the globe turning their attention to now discounted assets in the U.S. with continuing erosion of the dollar.
- The U.S. Federal Reserve will likely provide ample liquidity to support the banking system which will have the potential to support valuations.
- Election year politics may provide additional support in the form of fiscal stimulus.
- Risks to the downside are rooted in fear and rest on the elimination of investor comfort that has accrued from

years of relatively stable economic and profit growth. A severe recession could provide the sentiment change required to fundamentally revalue U.S. equity markets.

- The key risk in the near-term is the inability of the U.S. Federal reserve to stabilize and restore confidence in the banking system.

While it is difficult to determine the direction of U.S. equity markets in the near term, we are confident in our expectations for continued market volatility as the opposing forces of central bank reflationary activity and retrenching corporate earnings wrestle for supremacy.

International Equities

In 2007, foreign stock markets appreciated over 16% in dollar terms. Currency was an important contributing factor, as the dollar contributed over eight percentage points of this return. Emerging markets led world equity markets, increasing nearly 40% and continuing a remarkable five year run. Europe (+14%) outperformed the Pacific (+5%), where Japan (-4%) continues to be a drag on performance.

Exhibit 7: U.S. Market Cap as % of World Market Cap



Source: Bloomberg

Structural Market Changes

Our continuing preference for foreign stocks over U.S. stocks rests on several factors. In the simplest of terms, the opportunity set is larger and growing rapidly. The U.S. is simply becoming a smaller factor in the world than it once was, whether we are talking about global trade, financial markets or other factors. Exhibit 7 shows the decline in U.S. market capitalization as a percentage of world market capitalization.

This raises an interesting challenge for us in setting a neutral weight for our asset allocation discussions. For a number of years, we have long over-weighted foreign stocks relative to historical norms and standards. With U.S. equity markets now constituting less than 35% of world market cap, even our strong lean toward foreign stocks may appear underweighted in comparison to global market capitalization weightings. We continue to increase our strategic allocations (long-term targets) in keeping with these structural changes, but tend to lag these benchmarks as a portion of the recent trend relates to recent foreign market outperformance and a weakening dollar, both of which may reverse at some point in the future.

Risks And Opportunities

While risks to investors are generally higher outside the U.S., and in some cases much higher, it is our belief that very experienced and risk conscious managers can navigate such risks for the benefit of investors and capitalize on opportunities. Foreign markets are generally less developed and are undergoing changes, both of which present inefficiencies and, in turn, produce winners and losers and a better hunting ground in which astute managers are more likely to prosper. More specifically, we currently favor international markets for the following reasons:

Valuations

While the valuation gap between the U.S. and international markets is not as compelling as the 30% discounts we witnessed from 2002 to 2004, valuations are still lower in many countries. European markets sell at about 13x earnings, representing a 10% discount to U.S. equity markets. Japan sells at a higher multiple of about 15x earnings, which is comparable to the U.S., but we believe this overstates valuations, as we discuss later.

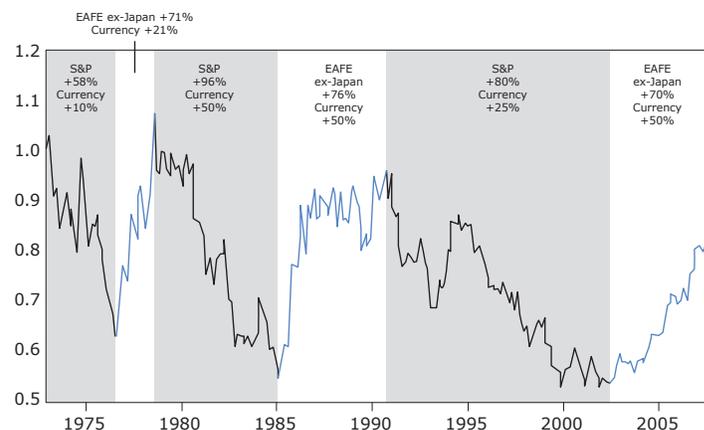
Growth Rates

A number of foreign countries exhibit higher growth than the U.S., providing a business environment in which greater business and profit growth are possible. Some of the Asian countries would be examples.

Restructuring and Rationalization

A number of the major foreign economies are undergoing

Exhibit 8: Return of EAFE ex. Japan vs. S&P 500



Source: GMO

an extended process of corporate restructuring and rationalization and of political change which may continue for several years. Germany and Japan are prominent examples of these changes. On the political front, France has joined Germany in a trend toward more conservative and, hopefully, business-friendly policies. Germany has lowered corporate tax rates from 52% five years ago to a projected 30% in 2008. The U.S. now has one of the highest corporate tax rates in the world, at about 40%.

Market Correlations

More broadly, while U.S. and foreign markets are highly correlated day-to-day, longer-term shifts in performance favoring U.S. or foreign stocks have been common in the past. Exhibit 8 shows that we have been in a trend favoring foreign stocks. However, many investors have jumped on this bandwagon and we have lost some of the fundamental underpinning of the prior valuation gap. Our long-term tilt toward foreign markets has been a key contributor to client performance over the last several years. While we continue to believe foreign stocks have the potential to outperform U.S. stocks for some period ahead, the magnitude of out-performance is likely to be lower and more variable than it has been over the last five years.

Currency Exposure

Our investment in foreign stocks generally benefits from a declining dollar as we prefer to invest in these markets on an unhedged basis. This stance is primarily driven by a desire to diversify our clients' predominantly U.S. dollar assets and our general goal of preserving real purchasing power on a global basis.

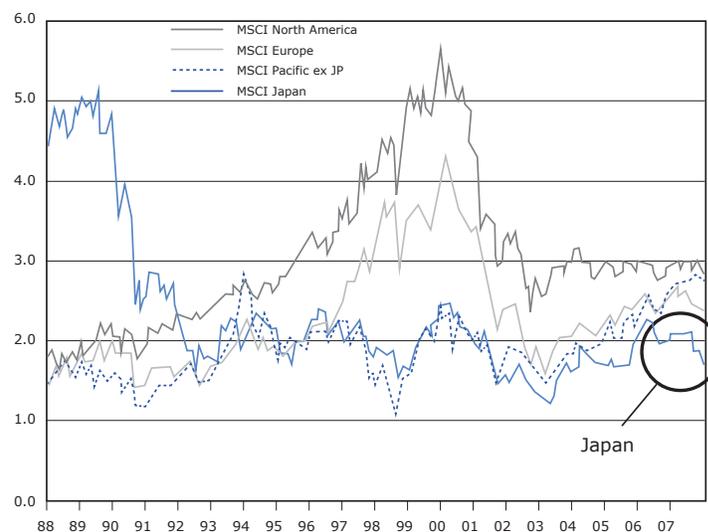
Japan

In the developed world, Japan has the greatest potential for a revival in economic and corporate performance through structural reform. However, in the near-term economic performance may following a weakening pattern similar to the U.S. Additionally, Japan has a number of longer-term structural problems (e.g., high government debt as a percent of GDP, aging population, deflation is still a danger and an impediment consumer spending, etc.).

From a valuation standpoint, Japan may be the most attractive market in the world. As an example, Exhibit 9 shows that Japan trades at a price/book ratio well below that of other markets. On a P/E basis, Japan seems less remarkable at 15x, but this is because Japanese corporations operate at profit margins that are well below those of other developed countries. While this sounds like a negative, we view it as an opportunity. One of the primary causes of low margins is the inefficient use of corporate balance sheets and the holding of excess cash reserves. However, we believe that Japan is current in the midst of a multi-year process to improve return on equity, supported by the following trends:

- The rationalization of much of the banking system, the reduction of large cross-holdings of securities that insulated management and a more optimistic business view by corporate management have moved Japan a long way toward better profitability and an increasingly more enlightened view of their obligations to shareholders.
- While Japan's top companies are sophisticated world-class competitors, many mid to smaller sized companies in Japan retain very inefficient balance sheets (e.g. too much cash) and are overly diversified with unfocused product lines.
- Japan's fear of losing its place as a regional economic power with the emergence of China have prompted a thaw in Sino-Japanese relations and energized reform efforts.
- The rising strength of activists in Japan, along with support from stock exchange and public pension authorities, lend themselves to better corporate governance and a higher focus on shareholder return by improving operational and financial management. As an example, a new law that took effect last May now permits a foreign company to acquire a Japanese company through a Japanese subsidiary. While activists in Japan have been set back in several recent proxy contests, it is generally believed that many of the changes they suggest will come to pass over the next few years.

Exhibit 9: Japanese Price/Book Ratio



Source: MSCI, Morgan Stanley Research

For these reasons, we have been building up a focused and activist oriented position in Japan among our clients' foreign investments. We want to caution that the headline numbers in Japan are not expected to improve much in the short run as the economy appears to be slowing in sympathy with the U.S. Additionally, the very process of rationalization and restructuring in the name of increased profits also constrains wage and employment growth and contains the potential for economic dislocation and financial pain. As Japan adapts to competitive and market realities, it should eventually demonstrate increased productivity and sustainable, positive GDP growth.

China

While China has been intriguing for many years, investment in China was largely out of the question for all but the most risk-tolerant investors. More recently, however, China has become "investable" and, in fact, very popular as an investment arena, as the Chinese government has made strides in privatizing its ownership of inefficient state-controlled companies, rationalizing the large backlog of bad loans in its banking system and establishing a more market driven economy. Many foresee strong and sustained growth in consumer-related industries in China as its emerging consumer class grows and becomes willing to consume more and save less. At this point, many such opportunities still involve high risks, are importantly illiquid and must be considered more like private equity investing. However, the forces in motion in China and the potential profitability appear to justify the risks of investing there now.

Given the long running increases in Chinese stock markets, valuations remain high despite recent declines. However,

these valuations may not be as egregious as they first seem given the continuing forecast of strong earnings growth in China. Moreover, our China-focused marketable equity managers are finding stocks with below-market P/E ratios and good growth prospects in this very inefficient market. To date, our investments in China have been relatively small, given the caution with which we must approach this market, particularly given current valuations.

We also have a strong interest in private investments in growth equity financings given the enormous scope in China for private to public market conversion over time. While China has 29 million small and medium sized business enterprises, it has fewer than 3,000 publicly listed companies. China's market capitalization as a percent of GDP has accelerated to 80% given their enormous market appreciation over the last few years. However, despite these recent increases, China still trails more developed economies with developed public market infrastructure such as the U.S. (132%) and the U.K. (162%). This very narrow public equity window, exacerbated by limited free float, into a very large, rapidly growing economy such as China when combined with surging investment demand is the primary reason for inflated valuation of public Chinese stocks.

Bond Markets

As we discussed earlier, higher quality bond markets benefited from a flight to safety and enjoyed a positive fourth quarter and year. However, lower-rated, higher yielding segments of the market were hit hard as credit spreads widened dramatically. For example, spreads on CCC-rated bonds increased from an estimate 480 basis points over Treasuries on June 30 to 877 basis points at the end of the year.

Somewhat surprisingly, emerging market spreads, which historically move in sympathy with U.S. high yield corporate bonds, have performed significantly better. On June 30, emerging market bond spreads were estimated at 160 basis points. Yield spreads ended the year only slightly higher at 214 basis points after improving slightly during the fourth quarter. Investors are likely reflecting their growing comfort with emerging economies and their increased resilience to withstand a U.S. recession.

As we look forward, the historically safe haven of municipal bonds is not without concern. Over the last few months, it has become apparent that municipal bond insurers, which currently guarantee approximately 50% of all outstanding municipal bonds, have some exposure to the credit problems in the taxable mortgage-backed securities market.

Most insurers are rated AAA, but it appears that one or more of these insurers could be downgraded, resulting in a corresponding downgrade of large portions of the muni market. However, most market participants believe that the impact of such a downgrade will be limited as a large portion of these bonds would be considered higher quality even without the insurance.

Credit Markets

Our long-standing fears concerning credit markets became front-page news during the second half of last year as the subprime market crashed and significant segments of the commercial paper market froze. Given the difficulty of assessing the underlying credit status of even major institutions, credit markets are still gripped by fear of where the next blowup or write down will appear. In this environment, credit spreads have widened significantly. Central banks were forced to inject liquidity and lower interest rates as even higher-quality financial institutions and their credit status came under suspicion.

In retrospect, the market's and our concerns at midyear about the possibility of increasing inflation and interest rates appear misplaced, at least temporarily. The flight to safety lowered rates for higher-quality debt, especially treasuries. Fears of recession, caused by the continuing decline in housing and the broadening subprime mortgage debacle, have lessened fears of increased inflation. While we would certainly agree that the prospect of higher interest rates and inflation in the near term has declined, the longer-term trend is not so clear:

- Barring a global slowdown, there is no indication of any lessening of price pressures from food, energy and other commodities. If we do not suffer a significant global slowdown, these pressures will likely continue or increase.
- The decline in interest rates over the summer is more a factor of flight to safety which hiked rates for low-quality credits while lowering rates for higher-quality debt. Unless expectations for the slowdown in the U.S. continue to worsen, this may be more of a technical and temporary decline in rates due to liquidity concerns rather than a reflection of underlying fundamental economic trends. It seems clear to most that the Fed would not have lowered interest rates except for the liquidity crisis in credit markets.

As we described earlier, we expect the problems in the housing market to create a general economic slowdown for the U.S. that will increase default rates on corporate bonds across a broad range of the economy. As a result of these conditions, we believe distressed debt investing will

become more productive over the next few years than it has been for a while. Such opportunities are likely to be more prevalent in smaller issuers given the very large resources available to the many large distressed debt players who can be expected to focus on larger issuers of questionable debt.

Hedged Strategies

Hedged strategies provided modest returns in the fourth quarter. While volatility remains high, which generally helps these strategies, continuing problems in the credit markets and declines in the equity markets, more than offset such benefits.

During the summer, it became apparent that some of the largest players, particularly those in statistical arbitrage, were operating with essentially the same strategies. When liquidity was withdrawn, similar securities were sold across a large number of major players creating very unusual losses for some of the market's most revered players, including in this case Goldman Sachs. A liquidity crisis often shows who has been swimming naked and this was the case for some players in the mortgage backed securities arena, most spectacularly Bear Stearns. It is another lesson in why we stress manager diversification so strongly in the hedged strategies arena, as even the best players can "go off the reservation," in this case involving too much leverage and securities which are too illiquid.

We continue to believe that large money flows to hedged strategies represent a secular issue as institutions increase their investment in this area to become more Yale-like in their investment approach. To accommodate this highly competitive environment, a number of the larger and better managed hedge funds have diversified their approach and moved further afield. Many have moved from a single-strategy focus to multi-strategy approach. Some have moved into leveraged buyouts or other forms of private equity and even into direct high-yield lending, much less liquid investments that imply heightened risk levels for some of these funds.

We are growing more concerned that this category has become systematically more correlated to other major asset classes as we mentioned earlier in our discussions of convergence. Despite our cautious outlook, we remain interested in the area. From a portfolio perspective, hedged strategies provide good performance potential with reduced volatility. Additionally, the returns in this area still tend to be less correlated with other major asset classes, providing a diversification benefit (albeit declining) which should reduce overall portfolio volatility.

Real Estate

For the 12 months ended September 30, returns for privately held, unlevered, core real estate properties were estimated at +17%. These are the most recently published data and reflect real estate's current yield plus appreciation. While these returns are quite strong, we believe the frenzied environment of the last few years has come to an end and these backward looking, appraisal based indices do not reflect, and will not reflect for some time, the likely fact that real estate values have declined in the last few months.

Commercial property cap rates appear to have softened over the last few months. Some in the industry have speculated that property values may have fallen 10%-20% from their frothy peak at the end of the second quarter. However, solid information will not be reflected in appraisals until there are a number of transactions reflecting these conditions and that will take a while.

Operating conditions in the U.S. and overseas continue to be good, but anecdotal signs of slowing have begun to appear as tenants are becoming reluctant to renew or extend leases as the possibility of a U.S. recession looms. In the last year, office rents in major international cities have increased although the advance has slowed recently. We are clearly seeing more difficult conditions in apartment and retail properties reflecting economic pressure on consumers and the housing and mortgage industries. In general, these conditions are at increasing risk of deterioration if the U.S. falls into a significant economic decline. In the longer-term, the chances of reestablishing positive fundamentals in commercial property are strong as little new supply is in the wings due to increased construction costs which are inhibiting new supply until rents increase significantly.

Longer-term Trends

Real estate continues to gain credibility as a mainstream asset class, both in the U. S. and overseas. U.S. retirement funds have less than 5% of their portfolios allocated to commercial real estate while many have come to realize the return and diversification benefits from a strategic allocation to this area. As a result, one major investment bank expects the allocation to commercial real estate by U.S. retirement plans to increase 50% (over \$350 billion) in the next three years.

Globally, this is supported by increasing transparency and more active capital markets as well as the increasing recognition that real estate is a major source of wealth around the world. The gross market value of commercial real estate worldwide is estimated at \$22 trillion. Cross border investment is increasing as greater understanding of the legal and political framework in which real estate assets

are acquired and sold around the world increases.

These trends provide continued support for asset values over a long period of time. The increasingly global nature of these highly-inefficient markets provides a growing array of opportunities in which our managers can apply their expertise in pursuit of value-added investment activity.

More specifically, we are now implementing a more concerted effort to increase our clients' investment in Asian real estate. The rationale:

- Asian populations are growing rapidly, which means demand for square footage also grows.
- As Asian populations develop a larger consumer class and increase their wealth, they "consume" more real estate per capita, thus further increasing square footage growth.
- The quality of much of the existing stock of real estate in many Asian countries requires a substantial upgrade.
- Valuations in some Asian markets are below those in the U.S. and Europe. In part, this reflects the lesser transparency of real estate markets in Asia. As Asian countries develop, this gap should diminish and valuations in Asian countries should more closely resemble those in the U.S. and Europe.
- Finally, while real estate markets are relatively inefficient compared to other asset classes on a global basis, these inefficiencies are especially prevalent in Asia given the early-stage of the development of investor owned, professionally managed, high-quality real estate projects there.

Additionally, while Europe does not exhibit the same growth characteristics as many of the Asian economies, our interest in European real estate continues to grow given fewer institutional buyers and more inefficient, regionalized markets.

Private Equity

Although private equity indices are flawed, Venture Economics reported a 23% increase for venture capital funds for the year ended June 30, 2007 and a 28% increase for other private equity funds, primarily buyout funds. This data is the latest available.

Market conditions for buyout funds, especially large buyout funds, changed dramatically in the summer of 2007.

Recall that large buyout funds had been enjoying a perfect environment, supported by compressed credit spreads, low interest rates, and extraordinarily easy lending terms with little or no amortization. Some LBO funds seemed to believe that their debt terms were nearly as valuable as the asset they sought to acquire. These conditions no longer exist and it may be some time, if ever, before debt markets provide financing on such attractive terms again. While valuations will not be available until after the end of the first quarter, it is likely we will see softening in the value of many of these investments and expected will diminish accordingly.

Changes in credit markets are less onerous for smaller buyout funds that were never able to access the extraordinarily favorable terms that larger players recently enjoyed. The current environment will also shift in favor of buyout managers who obtain their returns importantly from improving operations as opposed to relying more on financial engineering through high levels of leverage and easy credit conditions.

The key risks in the area remain the extraordinary amount of capital that has been raised in the buyout industry and a slowing U.S. economy which may severely hurt some of the existing, over-levered deals. While the retraction of easy debt financing is expected to lessen the trend toward higher acquisition multiples, the pressure to put money to work may simply force buyout managers to invest more equity in each deal, while continuing to pay high prices and accepting lower returns for their investors.

Venture capital fund flows, including the capital raising of the largest and most prominent managers, have declined greatly since the tech bubble in the late 1990s. Currently, the venture capital industry is in balance in terms of capital raising and deployment of assets, somewhat in contrast to most other asset classes which have been inundated with liquidity to a much greater degree. This might suggest that venture capital should be looked at more carefully as a potential investment area. However history has proven that only a few successful managers dominate and control the best deals and access to these select managers is a threshold investment issue.

Returns from venture funds have been systematically impeded by the Sarbanes-Oxley legislation, which raises the hurdle for an IPO of a small company. The result has been fewer exits through IPOs. This makes venture capitalists more dependent on strategic buyers for an exit, and there are often not many to choose from. Some worry that the venture capital model is breaking down and will be less profitable. Some established managers are moving more towards late stage and growth capital investments to reduce the time to investment realization and collection of

their fees. This may leave early stage investments orphaned and more attractive if this trend continues.

Venture capital and growth capital investors are becoming more active overseas, especially in China and India. It is expected that these higher-growth areas will continue to become an increasingly important part of private equity investing.

As our clients know, we have broadened what we call "private equity" beyond the traditional venture capital and LBO areas to include non-liquid investment strategies other than real estate. This broader scope reflects our recent experience that, in our search for attractive opportunities in an era of low expected returns, we are increasingly led to non-traditional and less liquid alternatives. As a result, we believe the investment opportunity set that we face in the intermediate term will dictate an increased percentage of our clients' assets be relatively illiquid. Our private equity and real estate partnerships will provide the vehicles to accomplish this.

Summary

The good news is that the fundamentals of the global economy appear likely to remain in a positive, though weaker trend in the near term. The bad news is that the U.S. appears headed for a significant slow down and possibly a recession, which will likely have some negative impact on our overseas trading partners. The possible silver lining is the world's increasing independence from the U.S. may provide better balance and possibly shorten or lessen the economic downturn at home.

Investment markets are beginning to reflect the severity of write-downs in the financial sector and the impact of the associated economic slowdown is being felt broadly across the economy. Corporate earnings and employment appear to be softening as well.

We are fortunate to have entered this crisis with equity valuations that were not significantly above their long-run averages, simply due to the fact that center of the excesses was in credit markets, not equity markets.

Markets are reacting with fear and uncertainty as the long-term picture for earnings and growth remains unclear. The bad news is that we expect significant volatility in the near-term as the equity markets attempt to find firm ground and will likely find false footing several times in the process. Over the longer term, we still see significant liquidity waiting to pounce on discounted U.S. trophy assets given the

decline in markets and the U.S. dollar. This will likely lessen the ultimate decline of U.S. markets and restore confidence faster than history might suggest.

We continue to seek out the best investment talent we can recruit to work for our clients and be sure they are fundamentally focused on the absolute value they pay for assets. Simply buying something well is a primary risk reducing factor. Although assets may decline from the level at which one buys them, a fundamentally fair purchase price should eventually yield a reasonable return and avoid permanent loss of capital. This is particularly important in more volatile markets that we experience. Currently, we are focused as follows:

- We are in an unusual period of convergence in pricing trends across asset classes. One might say that market efficiency has come to asset allocation. As a result, we believe that asset allocation will be a less useful tool and that implementation within asset classes will be at a premium.
- Within stock markets, emphasize activist managers who can benefit from the trend toward better corporate governance and accountability to shareholders in unlocking values in companies who have not rationalized their businesses for the benefit of their shareholders.
- From an investment perspective, distressed markets often create opportunities. Specifically, we believe the opportunities in distressed debt will become more plentiful as investors begin to look through the sub-prime rubble. If the economy continues to slow, we expect the distressed opportunity to expand further to other sectors.
- Continue to emphasize foreign stocks over U.S. stocks. Given the out performance of foreign stocks over the last few years, the U.S. could be due for a period of out performance. However, foreign markets provide better valuation, a higher growth environment and a better opportunity set, in part due to a combination of ongoing corporation restructuring and rationalization.
- Within foreign stock markets, focus on the restructuring and rationalizing potential of companies in Japan, and on China in its transition to a risky but investable market. Such investments are likely to require a higher tolerance for illiquidity and higher risk, supported by higher potential return.
- Due to the longer-term possibility of higher inflation and limited room for interest rates to decline further, we recommend reduced exposure to broad fixed income markets. Our concerns about the credit markets allowed

our clients to avoid significant losses in 2007. As we move forward, we will likely increase our emphasis in the distressed debt area, remembering that we view this as an equity substitute and not a fixed income investment.

- Maintain hedged strategies exposure, but migrate toward managers who have restrained their assets under management so that they can focus their investments on a relatively small number of top hedged strategies managers. We are concerned by the growing convergence of this area with traditional stock and bond risks. However, we believe investments in this area still hold diversification and performance benefits (albeit diminishing) for investors.
- Build real estate exposure, both in the U.S. and internationally. Operating fundamentals may slip in the short-run, but long-term fundamentals appear attractive. Real estate remains a highly inefficient market, allowing our managers to find discrete opportunities that can provide attractive returns. As the institutional appetite for real estate investing grows, we seek to work with managers who will feed these appetites by creating the stable, income-producing assets that institutional capital and REIT investors desire. We will focus more on creating opportunities in the growing and still less efficient Asian markets.

- We continue to expand our definition of private equity to areas beyond traditional buyout and venture capital investments as we find attractive investment opportunities which have longer investment horizons and provide less liquidity for investors. We remain cautious on large buyout investments as purchase prices have been high over the last several years, reducing return potential. We continue to expand our non-marketable investments in overseas markets to capture opportunities in these less efficient and high growth potential markets.

While the recent turbulent markets have again proven the value of our risk conscious investment approach, we expect that this market will provide more balanced opportunities in the short run. While we don't wish a recession or significant market decline on anyone, it may be the tonic required to systematically return appropriate risk premiums to many markets. In either case, it is our charter to remain very conscious of risk at all times and to pursue only those opportunities whose rewards justify the risk taken. If an increasingly risk tolerant and complacent trend returns, it is likely that Gresham's risk-conscious approach will cause our clients' returns to lag popular indices for as long as these conditions persist. We also believe that our clients may have to endure somewhat higher illiquidity, as the opportunities we currently perceive to be attractive tend to be in less liquid areas.