

Gresham Partners, LLC

Annual Outlook 2007

Exhibit 1 to the right shows data on indices that we can measure as of March 31.

Broad U.S. stock market indices increased slightly, up a little over 1% during the first quarter. Smaller companies did slightly better but the real disappointment was in the very largest companies, as the top 50 declined almost 2%. The best performers were in the mid-cap range, which advanced by a little over 4%, in part because that is where the merger and acquisition boom is centered.

Within sectors, the best performers were materials (+9%), utilities (+9%) and telecom (+7%). The laggards were financials (-3%), technology (-1%) and consumer discretionary (-1%). Growth slightly outperformed value in the mid-cap and smaller cap issues, but there was no discernible advantage on either side for larger companies which dominate the averages.

Foreign stocks, on the other hand, had a good quarter and were up nearly 4%, continuing their fairly long trend now of outperformance versus U.S. stocks. A decline in the U.S. dollar contributed about 1% to foreign stock performance.

U.S. bond markets performed reasonably well during the quarter, up 1%-2%, as yields were flat to slightly lower. Hedged strategies performed well, up a little over 3%.

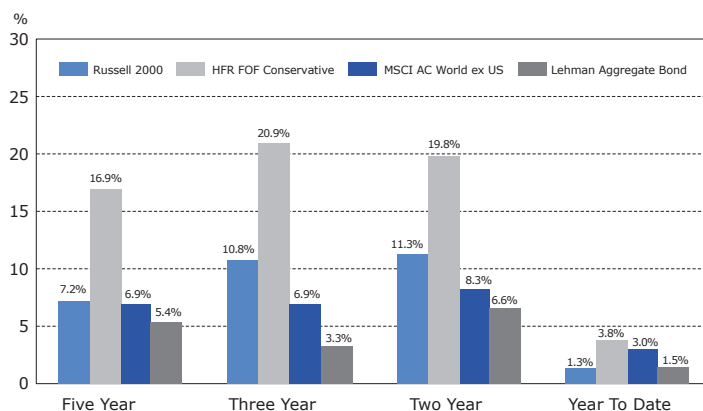
We do not have comparable data to include in Exhibit 1 for the nonmarketable real estate and private equity markets. However, real estate markets continue to provide unusually good returns on a global basis, with foreign markets providing somewhat higher returns than those in the U.S. Within private equity, venture capital continues to provide average returns while leveraged buyouts are generally providing unusually good returns.

Overview

While a good case can be made that global economic and business conditions will remain positive for a period ahead, the risk/reward equation for investment markets remains generally uninspiring. This presents a frustrating time for professional investors like ourselves.

The case for a continued positive global economic and business trend rests on two primary beliefs. First, that we remain in an extended era of continuing global growth and low inflation fueled by the industrialization of China and other emerging markets in Asia, Eastern Europe and Latin America and through restructuring and rationalization in Europe and Japan. Second, that the slowdown in the U.S.

Exhibit 1: Historical Performance



will not abort this trend.

As we have discussed in prior reports the effects of industrialization of China and emerging markets and the restructuring in Europe and Japan, we will not elaborate extensively on them here again. Suffice it to say that the industrialization of China and other emerging markets is likely to be a very long trend which can ultimately produce an enormous number of new consumers of goods and services and act as an engine of global growth far into the future. The ongoing restructuring and rationalization in the developed countries in Europe and Japan is also a long trend likely to last a number of years, producing low inflation growth in business and profits.

Many economists look for a more desynchronized world in which the U.S., formerly the world's economic engine along with China, gives way to a world in which China and other emerging markets, Europe and Japan provide leadership in economic growth. This thesis could be derailed, however, if the slowdown in the U.S. becomes too great a drag on the rest of the world and, in the last quarter, conditions in the U.S. continued to deteriorate. These conditions include the continuing housing slump, softer retail sales and capital spending and declining expectations for corporate profit growth. The debacle in the subprime mortgage markets further dampened the prospects for a recovery in housing anytime soon and led to fears that the easy credit conditions which had supported consumer and investment spending would become tighter. These concerns are mitigated by the current high level of employment in the U.S., the fact that disposable income is up about 5% year-over-year and that the subprime mortgage debacle seems contained with little effect on overall credit market conditions or interest rates to date.

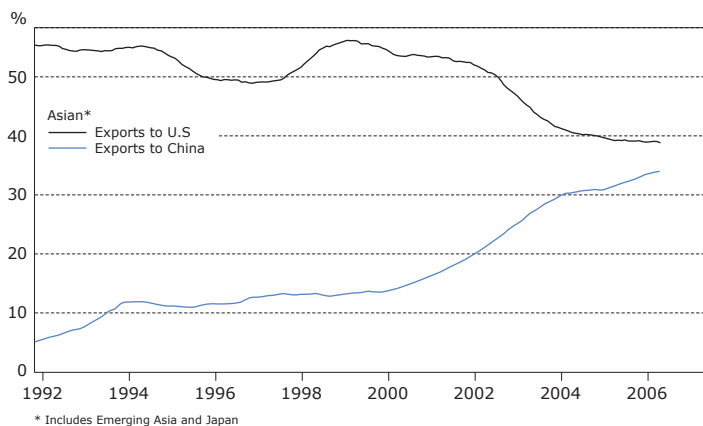
Perhaps the most interesting aspect of the debate on the importance of the U.S. slowdown is that it has revealed

that the U.S. is less of a factor today than it has been, and the U.S. seems likely to become a still smaller factor going forward. Examples:

- The U.S. has become a smaller component of world GDP and global trade. As an example, Asian countries other than China now export nearly as much to China as they do to the U.S. See Exhibit 2.
- The IMF has done a recent study on trends in the influence of the U.S. on economies and financial markets in other countries. Despite the fact that world trade is more integrated than ever and financial markets are more tightly linked, the U.S.'s smaller relative weight in world GDP and trade, though still the largest factor overall, has lessened its influences, particularly on economic growth. The linkages are stronger among financial markets as the U.S. is at the core of the global financial system, although this is also in a state of decline as the move to foreign markets by new issuers reflects. The study notes that linkages between a slowdown in the U.S. and other economies overseas is weakest when the factors are localized, as is the current case in which housing is expected to be the primary depressing factor in the U.S. economy. Interestingly, the IMF study goes on to note that the linkage between the U.S. and other nations is much stronger when trends are deteriorating significantly than when they are neutral or expanding. The upshot of this seems to be that if the U.S. suffers a mere slowdown, say to 1%-2% GDP growth, the continuing positive global growth trend, though desynchronized, is likely to continue. However, if the U.S. incurs a recession, its effects may be much more pronounced and lead to a global growth slowdown or recession.
- The percentage that U.S. stock market capitalization represents to the rest of the world has declined to 35%-45%, depending on what database is used. A few years ago, it was more than half. In part, this just reflects the recent outperformance by foreign markets, but it also reflects the rapidly expanding number of public companies in other parts of the world and the fact that, to an increasing degree, new issues are floated on foreign exchanges. If one assumes that China, India and other emerging markets will continue to develop, they will likely create large numbers of new public companies with increasing market values.

The decline in importance of the U.S. in global economic trends and in global financial markets has implications for investors, as does the potential for a more desynchronized trend among nations.

Exhibit 2: China Versus U.S.: Trading Places



Source: BCA Research

- With the U.S. likely to account for a decreasing share of world market capitalization, the opportunity set outside the U.S. is enlarging.
- Desynchronization among nations indicates that business conditions will be significantly better in some nations than others, supporting a more global or international mindset by investors.
- Industrialization, restructuring and rationalization expected overseas involve significant changes that are more likely to present an opportunity than the more stable conditions expected in the U.S.
- In emerging markets such as China, in which the vast majority of businesses are privately held and market capitalization is expected to grow rapidly through a movement from privately held to publicly held businesses, unusual opportunity may be found in a growth equity and pre-IPO financing provided to attractive privately held businesses.

These factors are likely to reinforce the trend toward international diversification away from the U.S. by investors.

Within the corporate world, conditions are relatively benign. While profit growth and margins are softening in the U.S., profits are still expected to rise and margins to decline only modestly. Overseas, profit growth potential is higher due to more rapid expected growth and the potential effects of restructuring and rationalization. Balance sheets for most companies remain in good shape, despite some growing concerns in lower quality credits.

Among the threats to a continuing positive global trend, domestic political and geopolitical concerns are in the

ascendancy. A desynchronized world creates winners and losers along with varying trends in economic growth, profitability and currencies. Rising protectionist sentiment in the U.S. and the increased influence of the Democratic Party, which has historically been more sympathetic to protectionist measures, could lead to actions that limit global trade and global growth. Recent actions by the Bush Administration, though rather insignificant themselves, could signal greater protectionist sympathy as well.

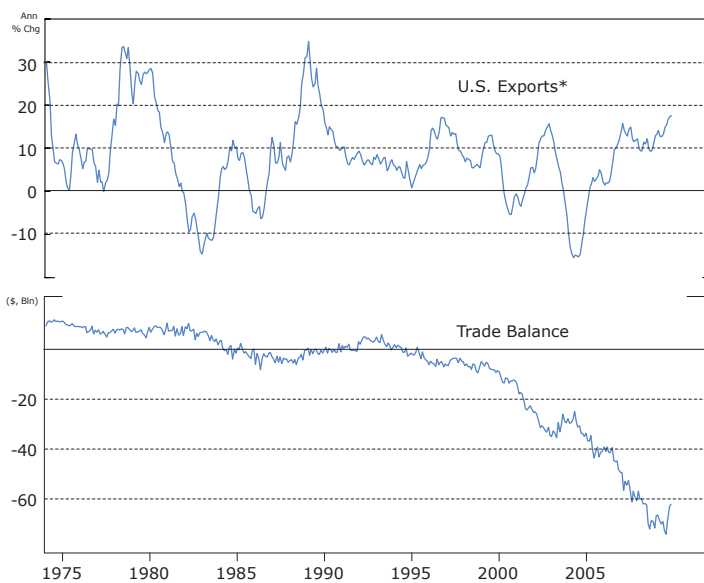
Geopolitical issues, if anything, continue to worsen. As one economist mentioned recently, "If I read the front page news, you would think the world has big problems, but the business section says things are about as good as they get." The problem with understanding the importance of geopolitical threats to public and investor psychology is that these threats do not matter until they do. In important part, the current greater geopolitical threat relates to the lack of alignment among nations in a period of heightened geopolitical stress. Unlike the Cold War, when nations were aligned across most important issues in two great competing blocs, the current world is multipolar. A nation aligns with another nation on a given issue but not on most others. The discord this produces makes resolution on any issue difficult. The implications for world trade and globalization are not positive as the current difficult, and possibly failed, world trade talks imply.

For reasons we describe in more detail in our review of bond markets, we have long felt that, should a financial accident occur, Ground Zero could be in credit markets. The subprime mortgage market debacle is a good example of the excesses that have existed in credit markets for some time, although it is now expected that this specific problem will be contained and will have little contagious effect elsewhere.

The world economy is not in equilibrium and has not been so for quite some time. The imbalances include the U.S. fiscal and trade deficits, inflation in U.S. housing prices, and the fact that corporate profit margins are far above long-term trends and have a longstanding, mean reverting tendency. However, in the case of the U.S. fiscal and trade deficits, the trend is improving. The fiscal deficit has declined from 4% of GDP to 2%. The U.S. trade deficit has stopped worsening and shows signs of improving, as shown in Exhibit 3. Given the rate of excess savings accumulation and the current levels of excess liquidity present, there seems to be little risk of problems on this front in the near future.

In the longer run, a serious risk could develop if the virtuous combination of global growth and low inflation, brought to us through the industrialization of emerging markets

Exhibit 3: A Cheaper U.S. Dollar is helping the External Sector



* Shown smoothed.
Source: BCA Research

and more efficient economies in the developed world, were to result in a glut of capacity and a global recession. This would be a case of a good thing carried too far, but this is the nature of economies and markets. Recessions brought on by excess capacity tend to be long lasting and very damaging, as compared to a shorter-term inventory correction. At the moment, however, this does not seem to be on the minds of economists or in the immediate future.

At the margin, China has become an indispensable player in the global growth scenario given the economic slowdown in the U.S. Should China falter, global growth prospects would be diminished. It is important to note that the size and scope of the changes being brought about in China are massive and difficult to control so mistakes or unexpected consequences are certainly possible.

As always, inflation trends are the primary driver of future expectations for economic, business and investment trends. An increase in inflation expectations would have particularly damaging effects on bond and stock markets through increased interest rates and lower price/earnings multiples. Inflation expectations wax and wane and may be currently in somewhat of an uptrend given renewed concerns about oil price increases and rising food prices. So far, wage inflation in the U.S. has been very modest.

Our greatest concern, however, it is that the very pleasant condition of rising markets that we enjoy today could ultimately lead us from the current era of uninspiring investment alternatives through another era of euphoria and

mania such as we experienced in the late 1990s and into an even riskier and more uncomfortable position. The conditions that might contribute to such an environment include:

- The U.S. moves through the current slowdown and resumes higher GDP growth rates.
- The belief that good worldwide economic growth with low inflation will continue for many years continues to gain broader acceptance.
- Liquidity remains in great abundance due to easy lending conditions and interest rates remain relatively low.
- The level of economic and market volatility, or perceived risk level, remains low to declining, resulting in increasing investor confidence that these conditions will persist. Volatility has declined in a wide variety of economic and investment barometers, including GDP growth, inflation and interest rates, credit spreads, stock markets and other aspects. See Exhibit 4 for lower volatility trends in some of these areas.

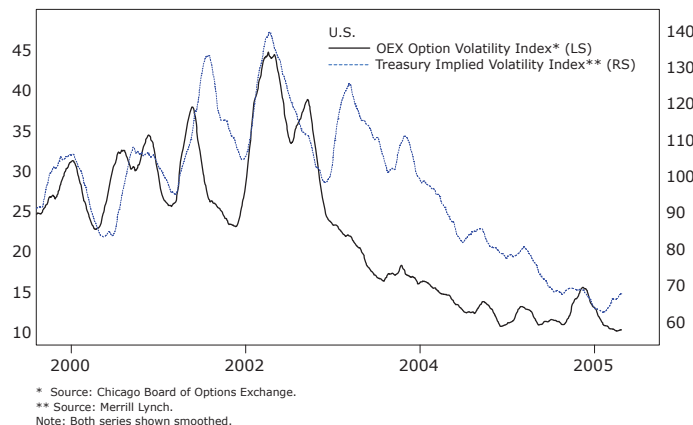
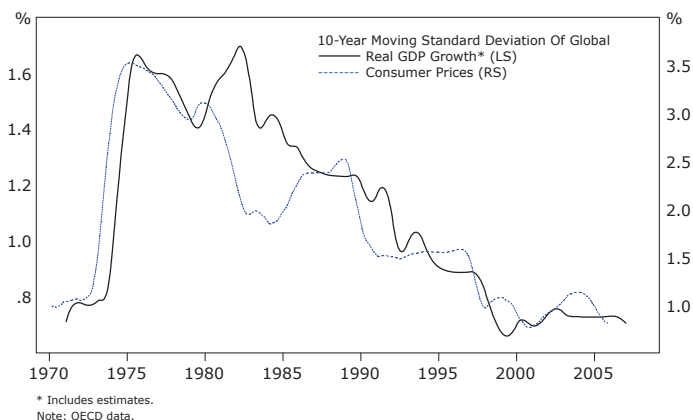
To the extent that these conditions persist, they have an increasing effect on investor psychology, leading investors to ever higher levels of comfort with and acceptance of increasingly higher valuation and risk levels compared to historical norms. As investor complacency grows and higher risk levels become acceptable, greater leverage is applied in a cycle which keeps inflating asset valuations.

The ultimate risk is that some event causes a collapse of acceptable risk tolerance. Some have referred to this as the "paradox of credibility" in which investors are lulled into a false sense of security causing an underpricing of risk, excess credit expansion, growing financial imbalances and overvaluation.

Such a scenario might be most likely to appear through a continuation of the rotating series of asset bubbles which we have seen over the last decade, first moving from stock markets in the late 1990s to the more recent housing bubble. The stock market bubble of the late 1990s collapsed and the housing bubble is now in the process of deflating. Our candidates for the next mania include:

- Emerging market equity and real estate. The very compelling, strong growth stories in countries such as China and India have the potential to capture the imagination of the investing world.
- Marketable equities in the developed world. U.S. stock market valuations have come down substantially since the bubble years of the 1990s to levels that are near

Exhibit 4: Increasing Economic Stability



historic norms. While no bargain, stock market valuations are cheaper relative to their historical valuation than are many other asset classes. If the avalanche of liquidity is looking for a home, stock markets in developed countries could become attractive.

- Real estate in developed countries outside the U. S. These markets have not been exploited to the extent they have in U.S.

One might ask, what is the problem with this scenario? It provides an opportunity to profit from rising asset values and we have some idea about where the increases might occur.

For risk conscious investors like Gresham and its clients, however, participation would require that we maintain investments in markets while they are appreciating far beyond historical norms on the theory that we will know when the music might stop. By contrast, our charter is to seek out managers who invest on the basis of a thorough understanding of fundamental value in absolute, not relative, terms.

Such managers commonly underperformed their benchmarks in the late 1990s as they avoided investment in companies whose valuation could not be understood or was not based on fundamental factors. While the absolute return of those managers and our clients was very acceptable, we were frequently asked in those years why we and our managers did not keep up with stock market performance and why our equity managers did not have greater participations in the companies whose stocks were performing so well during that time.

Our answer was then, and will be now, that our first obligation is to take risk only when the rewards are justified. In an era of great investor complacency and declining perception of risk, this is difficult to do today and could, in the scenario described above, become much more difficult. If that is the case, it is likely that our clients will participate in rising markets but will not succeed to the degree that other more risk tolerant investors do in an era in which risk taking is highly rewarded. This is not merely a cautionary note as we believe this scenario is quite plausible.

We hasten to add that if markets declined broadly, our managers would likely suffer losses. However, we believe these losses would be well less than those incurred by inflated markets and should entail little risk of permanent loss of capital as the managers' investment decisions are based on fundamental valuation rather than valuations relative to other companies in an inflated market.

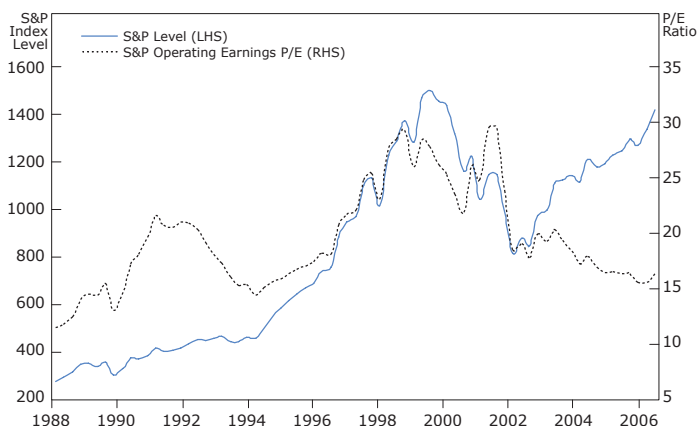
This is the world we live in and we cannot change it. Since the answers to many of the questions noted above are unknowable, we continue to develop our strategies by focusing on people and ideas that we believe can be productive for our clients over the next several years, while keeping an eye on long term trends and risk. Let's look at the investment markets themselves and how we are trying to navigate the current conditions.

Domestic Equities

Estimates for operating earnings for the S&P 500 for the year 2007 have been declining and are now in the 6%-7% range. The expected pattern in 2007 is interesting as it assumes a trend reversal in which yearover-year earnings increases bottom out at about 4% in the first quarter and rebound to about 11% by the fourth quarter. The longer-term average is about 8%.

Based on the current estimates, the S&P 500 was trading at about 15x projected 2007 earnings at the end of March. The long-term average for the P/E ratio on forward earn-

Exhibit 5: S&P 500 P/E Ratio vs. Index Level



Source: Standard and Poors

ings is about 15x, although these data mix reported and operating results. In more recent years, when operating data were used, the forward average was about 12x.

Some analysts see the current modest level of earnings growth continuing for an extended period. They note that U.S. corporate profits have increased 190% in the 52 months since the earnings expansion began, and a slowdown to a more normal long-term average should be expected.

It is certainly fair to say that the combination of increasing corporate earnings and lesser increases in stock prices in recent years have improved the valuation of U.S. stocks. With P/E ratios now near their lowest point since the mid-1990s, the subject of fair valuation is hotly debated. Exhibit 5 illustrates the divergence of the P/E valuation of S&P 500 and the Index.

As always, there are two primary questions: what is a reasonable expectation for the rate of growth in corporate earnings and what multiple should be attached to those earnings. We expect that U. S. corporations will continue to prosper and that earnings will grow at a healthy, but reduced, rate. Our expectations for earnings growth tend to be muted by the following:

- Operating margins are near historic highs and have a long-standing, mean reverting tendency (see Exhibit 6). A reduction in margins is likely to retard earnings growth.
- Over long periods, corporate earnings are grounded in nominal GDP growth, currently expected at 5% - 6%. Corporate earnings grow faster than GDP by virtue of

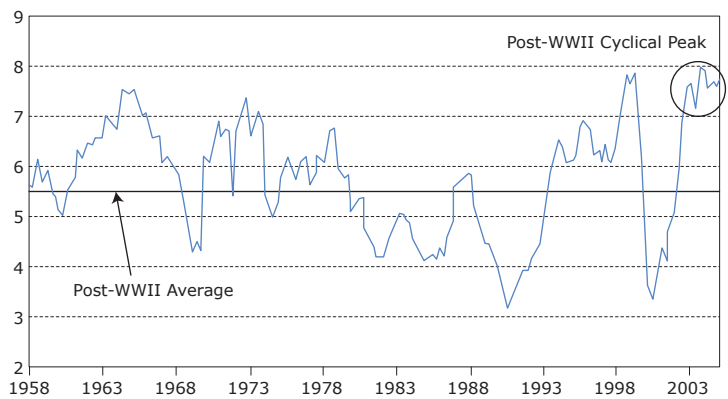
increased productivity, financial leverage and, potentially, margin expansion. On this basis, it is hard to see how corporate earnings growth can be sustained beyond the high single digits for long periods without high leverage.

- The extraordinarily easy lending conditions now prevalent in credit markets are supporting stock prices because they enable the boom in merger and acquisition activity and analysts' search for the next company that may be taken private. If credit markets become more cautious, this could change.
- Earnings growth forecasts have a strong tendency toward over optimism. One of our managers has done an 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. On the corporate side, the 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, about 20% over the period 2002-2005. On the analysts side, forecasts of operating earnings have overstated later reported earnings actually realized by over 10% in recent years. The combined effect of the overstatement by corporations and analysts could result in earnings estimates that are 30% overstated, meaning P/E multiples are actually much higher than the market thinks they are at any point in time.

While earnings are not easy to predict, changes in stock market multiples are still more difficult to forecast as they depend so much on perception and psychology. The deflation in U.S. market P/E ratios from 2000 to the current time is a recent example. With the current U.S. stock market trading near its historic norm, we believe that U. S. markets should move higher based on earnings increases alone and that we would not depend on multiple expansion. Moreover, the current multiple could be at risk if earnings growth stays near the long-term 8% average. Despite this, it is quite possible that investors will focus on the U. S. and other developed stock markets as a relative bargain in their search for return in a world of low returns and will thus be willing to accept higher valuations.

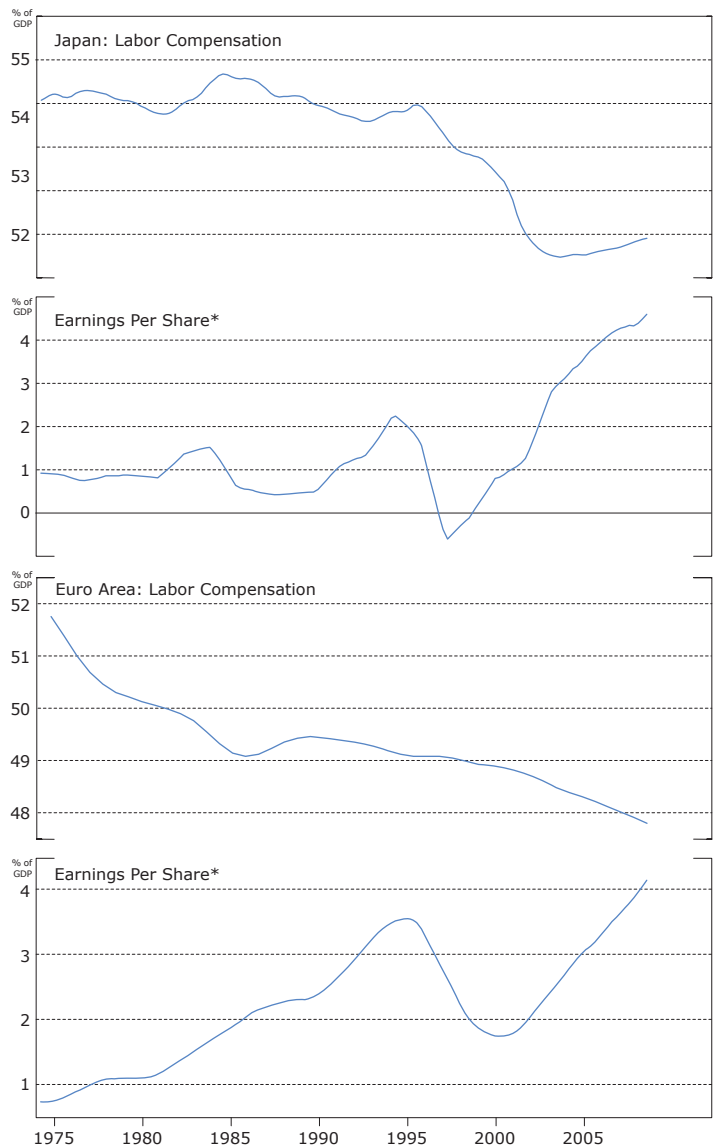
Large, high-quality companies continue to underperform despite the fact that many recognized value investors find the best valuations in U.S. markets in these companies. It is generally felt that less buoyant business conditions may be necessary for these companies to be better appreciated

Exhibit 5: S&P 500 Profit Margins



Source: GMO

Exhibit 7: Japan and Euro Area: Becoming Pro-Business, Anti-Labor?



* Based on Morgan Stanley Capital International data
All series shown smoothed.

Source: BCA Research 2007

for their stronger businesses and balance sheets. However, others feel that these companies are susceptible to poor capital allocation decisions, as their very large size would seem to preclude a going private transaction or other activist effort to achieve better shareholder returns.

International Equities

Foreign stock markets appreciated about 4% in the first quarter of 2007 in dollar terms. Europe (+4%) slightly underperformed the Pacific (nearly +5%). Japan continued to lag a bit, up a little less than 3%. Emerging markets were up about 2%. Currency was a minor contributing factor as the dollar depreciated a little less than 1%.

The forward P/E ratio is 13x in Europe and 15x in Asia, compared to 15x in the U.S. The dividend yield in Europe is more than twice that of the U. S. Based on these facts, we may have some additional closing of the valuation gap.

What valuation metrics do not capture, however, is the larger potential for restructuring and rationalization to improve corporate profitability in developed markets overseas, a process that is catching up but has lagged that in the U.S. While both European and Japanese companies have lagged U.S. companies significantly in acclimating to the new imperatives of trade globalization, the process is underway and contains the ability for a catch-up by taking measures that have already taken place in the U.S. to improve profitability. The current wave of activism sweeping over major stock markets and less inhibition to such influences through reduced corporate cross-ownership and governmental interference are likely to encourage similar changes over the next few years. You see this clearly in Europe, where major companies have taken steps to substantially increase their profitability despite difficult and rigid governmental inhibitions in the form of inflexible labor markets, high tax rates, etc. Exhibit 7 shows the effects of rationalization in Europe and Japan.

Japan and China deserve special note given our increasing interest there. In the developed world, Japan likely has the greatest potential for a revival in economic and corporate performance. This has not gone unrecognized, as Japan's stock market has more than doubled from its bottom in 2003. Given this extraordinary rise, a correction in Japanese markets occurred in 2006 and more could occur, but the long term is potentially attractive to investors in Japanese companies, particularly those below the top echelon.

While Japan has a number of ongoing problems (e.g., high government debt as a percent of GDP, aging population,

Exhibit 8: S&P 500 Profit Margins



Note: 6 month moving average

Source: GMO

deflation is still a danger and an impediment to consumer spending, etc.), we see the following attractions:

- The rationalization of much of the banking system, the elimination of large cross- holdings of securities that insulated management and a more optimistic view by corporate management have moved Japan a long way toward better profitability and a more enlightened view of obligations to shareholders.
- While Japan's top companies are sophisticated world-class companies, 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.
- The rising strength of activists in Japan, along with enabling legislation which supports improved shareholder rights, 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 will take effect this May will permit a foreign company to acquire a Japanese company through a Japanese subsidiary.

- Tougher competitive conditions brought on by globalization also support a more energized and shareholder focused corporate management.
- While cumulative corporate profit growth since 2001 in Japan is up 95%, profit margins are still only about half those of U.S. and Europe, indicating major room for improvement.
- The forward P/E ratio in Japan is about 17x. While this is somewhat above the level of other major markets, profit growth and margin improvement potential in Japan is also higher. P/E ratios in Japan are also inflated by large, low yielding cash holdings in some companies. Moreover, while we are not a fan of justifying P/E ratios based on interest rates, we note that interest rates in Japan are far below those of other countries, at well under 2%. See Exhibit 8 for data demonstrating Japan's relative cheapness.

For this reason, we have been building 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 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, however, it should eventually demonstrate significantly increased productivity and sustainable, positive GDP growth. See Exhibit 9.

We earlier noted the economic potential of China as it industrializes. While China has been intriguing for several years, investment in China was largely out of the question for all but the most risk-tolerant investors. More recently, however, it appears that China may have become "investable," as the Chinese government has made strides in rationalizing its ownership of inefficient state-controlled companies and the large backlog of bad loans in its banking system. Many foresee strong and sustained growth in consumer-related industries in China as its emerging consumer class grows and becomes more willing to consume more and save less. At this point, such opportunities still create 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 they may enable justify the risks of investing there now. The very strong Chinese markets in 2006 will slow our progress in the near term, in both public and private markets, as a correction in China's upward surge is very possible.

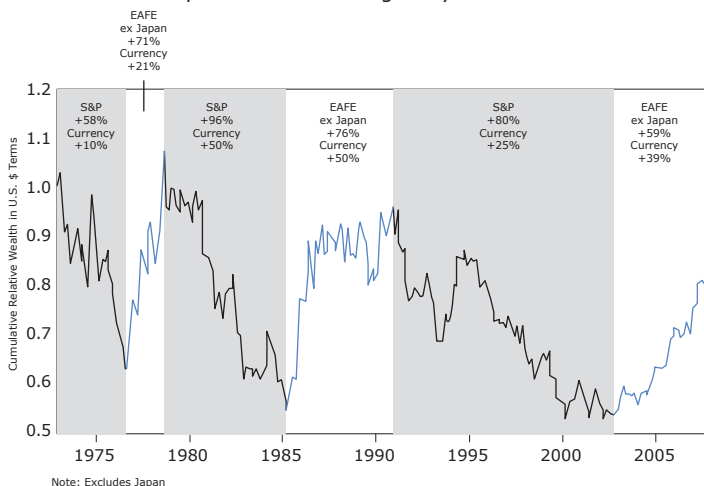
Given the recent huge increase in Chinese stock markets, it is estimated that the forward P/E ratio for Chinese stocks

Exhibit 9: The Japanese Restructuring Story



Source: GMO

Exhibit 10: The Japanese Restructuring Story



Source: GMO, Standard and Poors

increased very substantially, though problematic to measure accurately. However, our chosen managers there are still finding stocks with low to average P/E ratios with very strong growth prospects in this very inefficient market. To date, our investments in China have been relatively small, given the caution with which we feel we must approach this market. As mentioned earlier, we prefer private investments in growth equity or pre-IPO 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 less than 3,000 publicly listed companies.

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 10 shows that we have been in a trend favoring foreign stocks, and we believe foreign stocks have the potential to outperform U.S. stocks for a period ahead.

The magnitude of out-performance in foreign markets versus the U.S. is likely to be well less than it has been over the last four years and will likely be much less consistent. This reflects the fact that many other investors have jumped on this bandwagon now and we have lost much of the fundamental underpinning of the prior valuation gap. Thus, while we expect trends to favor foreign stocks further, the trend may be more in a seesaw pattern.

While investment in foreign stocks would benefit from a declining dollar, and popular belief is that the dollar will decline over the next several years, we have been reluctant to put much weight on a declining dollar as a rationale for owning foreign stocks. Exhibit 11 shows why, namely, that the dollar is not expensive in terms of purchasing power parity against other major currencies. Moreover, the U.S. fiscal and trade deficits have been improving. If the dollar declines, it will have to be based on the worldwide imbalance in current accounts and resulting fund flows, but the current era of abundant liquidity and excess savings does not seem likely to call for a day of reckoning just yet. Also, foreign central banks, which hold vast amounts of dollar denominated assets as reserves, are not profit oriented. A falling dollar matters less to them than managing their own currency value and domestic money supply.

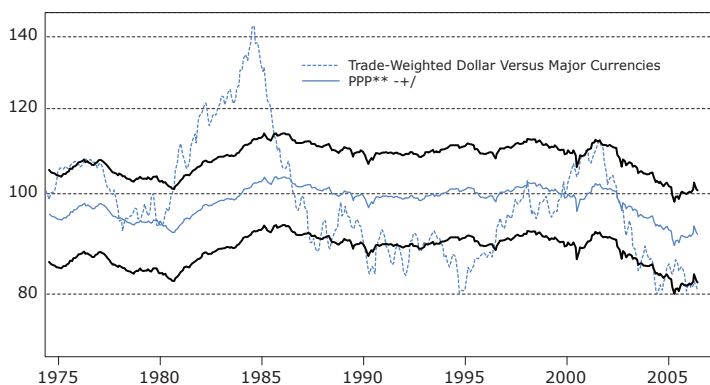
Fixed Income

The U.S. bond market performance was adequate in the first quarter of 2007. As examples, the ten-year treasury returned 1.7%, investment grade corporates returned 1.5% and intermediate municipals returned about 1.5%. High yield bonds returned 2.7% and emerging country debt returned 2.5%, with these riskier categories showing no ill effects from the problems in subprime mortgage debt.

If inflation can be maintained at around 2% or less, then real interest rates have moved near historical norms and should remain relatively stable. The current conditions of abundant liquidity and excess savings would also tend to call for stable interest rates.

We would be remiss, however, if we did not mention the risks of our complacent view of interest rates. U.S. fiscal policy, though improved, has been remarkable for its lack of restraint. Typically, a sustained fiscal drain such as the war in Iraq would call for some combination of spending restraint and tax increases. While efforts have been made,

Exhibit 11: The U.S. Dollar is Cheap



* Defined as the Canadian dollar, Japanese yen, British pound, Euro, Swiss franc, Australian dollar and Swedish Krona.

Source: Federal Reserve

little has been accomplished in the current divisive political environment. Moreover, if the trade and fiscal deficits of the U.S. are to moderate further at some point in the future, many believe a decline in the value of the U.S. dollar will eventually be required, which would tend to increase U.S. inflation and interest rates. Lastly, increased commodity and food prices have yet to trigger higher inflation expectations, but it can happen.

While we are relatively sanguine concerning interest rate trends, we remain concerned about credit issues. Complacency in bond markets has been especially evident in historically low credit spreads and deteriorating credit analysis.

Our fears were partially realized in the last quarter, as the subprime mortgage debacle became front-page news. The subprime mortgage problems reflect two of our issues in credit markets:

- Price-based risk modeling concepts have importantly replaced experienced credit analysis. Such models and the tranche structuring on Wall Street combine to produce derivative instruments of great complexity that are very difficult to analyze. Moreover, these models are untried.

In this case, subprime mortgages were bundled into residential mortgage backed securities ("RMBS's"). The RMBS's were then segmented into tranches with the bottom tranches taking the first losses from defaulting mortgagees and those at the top best protected from loss, even though they consisted entirely of subprime mortgages, the poorest credits available in mortgage markets.

Wall Street investment banks then took the lower and most risky tranches of the RMBS's and bundled them into collateralized debt obligations ("CDOs"). These CDOs were

further segmented to create tranches, with the bottom tranches taking first losses and those at the top best protected. Believe it or not, the top tranches of these CDOs (consisting entirely of the lowest tranches of RMBS's) can receive AAA credit ratings. Issuance of such CDOs increased from \$10 billion in 2001 to \$114 billion in 2006.

- One might ask how could such ridiculous debt instruments be constructed, which brings us to our second credit market issue - the decoupling of ownership and accountability for risk assessment created through the growth of conduit asset-backed financing in which loan originators no longer retain loans they create. This is very unhealthy for the quality of risk analysis. In the case of subprime mortgage loans, the loans were originated by mortgage bankers who often had little interest in the loans, except for the origination fee. These loans were passed on to Wall Street bankers who are paid richly to bundle these loans into RMBSs and later CDOs that they sell to the ultimate owners in complex, tranche structured portfolios that are difficult to analyze and to rate.

Our issues with the credit markets are not confined to the subprime mortgage market. More broadly speaking, here are some other issues to consider.

- We are in transition from an era of bond-friendly transactions, as corporations improved balance sheets and increased cash positions, to an era focused more on actions friendly to equity holders, as more aggressive use of balance sheets by corporations is sought through such measures as stock buybacks and acquisitions. The recent spate of leveraged buyouts is forcing much more aggressive use of balance sheets, in some cases reducing investment grade debt to junk overnight.
- The enormous issuance of high-yield debt in recent years has greatly changed the quality of the corporate bond sector. Today, two-thirds of corporate bond debt is rated as "junk" versus 3% in 1980 and this preponderance is still rising. While some of this change has been caused by the downgrade of some very large companies, such as GM and Ford, the high-yield corporate bond market now accounts for \$3 trillion, not much less than the treasury market at \$4 trillion. High yield bond issuance in 2006 was a record \$127 billion, but this was dwarfed by issuance of \$500 billion of leveraged loans, much of which fueled the mergers and acquisition spree. At this point, and despite the tremors caused by the subprime mortgage issues, leveraged loan issuance in the last quarter was up 55% year over year.

- The huge growth of credit default swaps may have anesthetized the buyers of high-yield debt, as they may hedge the credit risk they buy and accept the higher interest rates of high-yield debt. The credit default swap carries not only the risk of untried derivatives generally, but many of the contracts are custom arrangements that are difficult to track and settle in the rapid trading environment of these markets. This settlement issue has yet to be fully resolved and the Federal Reserve is clearly now focused on it. Currently, exactly who bears what risk may not be clearly defined.
- Credit quality spreads are near all time lows and rose only very slightly in the wake of subprime mortgage issues. We question whether investors in the lower grade credits are being paid fairly for the risks they are taking.

At some point, the credit issues we note were likely to lead to investment opportunity, and we finally captured a small benefit through an investment that is essentially a short on the lower tranches of subprime mortgage CDOs. We believe that there will eventually be other opportunities. However, if we are in an era of decent economic growth, moderate interest rates, great liquidity and investor complacency, we may have to wait a while to find them. Typically, major opportunities are caused by an economic downturn or a period of heightened lending requirements and interest rates.

Hedged Strategies

Although hedge fund indices are seriously flawed and must be viewed as more anecdotal than factual, they indicate that hedged strategies performed well in the last quarter, up about 3%. Returns were good across major strategies, except for macro traders who were barely positive for the quarter.

While investor expectations as to the benefits of hedge funds remain exaggerated, they are beginning to become more realistic given modest returns in recent years. In great part, this reflects the increasingly crowded field and the fact that a number of hedged strategies cannot accommodate large amounts of capital. To give you an idea of the scale of the competitive issue, consider that while hedge funds have grown enormously, now with assets under management of well over \$1 trillion, the proprietary trading desks of financial institutions have grown even faster and recently accounted for over \$4 trillion of assets invested in many of the same strategies. The investor's predicament is further compromised by the fact that many of the best

managers have reached very large size and have closed to new investors, or even additional capital from existing investors.

To accommodate this highly competitive environment, a number of the larger and better managed hedge funds have diversified their approach and moved further a field. Many have moved from a single strategy to multiple strategies. 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.

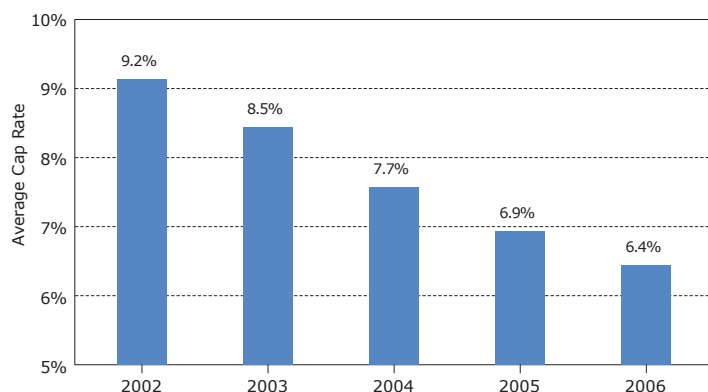
Our expectation for hedged strategies returns remains below historical levels. Some of the arbitraging strategies are recovering from their poor results of recent years, but the large flow of money to hedged strategies is a secular trend that is likely to constrain returns for a sustained period. While our managers have exceeded their benchmark for hedged strategies (T-bills + 5%) by a comfortable margin in the last ten years, they may be hard pressed to reach that benchmark in the next several years because of the amount of competitive capital at work in the field.

2006 contained a spectacular collapse of a major hedge fund, Amaranth, which illustrates an important tenet of our investment approach to this area. This debacle occurred despite the lead investor's long and highly respected career in the field because he allowed a single trader to take an extraordinarily highly leveraged position in a volatile asset class in very large size. While the manager did not conceal this position, it emerged fairly quickly and many major investors in the field, including some of the major investment banks, incurred heavy losses on their investment in Amaranth, which approximated two-thirds of the funds total capital.

What this incident reinforces is that the principal risk that one must diversify in hedged strategies investing is not the underlying investments, which are very highly diversified in the great majority of cases, but instead the risk of a failure by a manager. The failure may be caused by fraud, venturing into an unknown area or simply a loss of investment discipline, as seems to be the case with Amaranth. Of all the areas of investment in which Gresham participates, the complexity and lack of transparency in hedged strategies makes it the field containing greatest manager risk. For this reason, that is where we focus on risk control.

Despite the cautious outlook, we remain interested in the area because we believe it attracts talented managers and that the long/short strategy is a powerful and potentially positive investment tool in the hands of the right manager. The challenge is to be sure one has a talented manager

Exhibit 12: Office Cap Rates in Washington D.C. Metro Area



Source: Delta Associates' Market Maker Survey; March 27, 2007, The JBG Companies

who has the understanding and ability to deal productively with the hedge fund format, including the risks of leverage and the unlimited loss potential of short selling. Such managers are rare.

Real Estate

For the twelve months ended December 31, returns for privately held, unlevered, core U.S. real estate properties were estimated at 17%. These are the most recently published data and reflect real estate's substantial current yield plus appreciation. U.S. REITs increased about 2% in the first quarter, while the global index increased 6%.

Operating conditions in the U.S. and overseas continue good and improving due to increasing rents and declining vacancy. These positive operating conditions are expected to continue given good, though slowing, economic trends and little new supply in the wings or likely in the near future. Construction costs have risen significantly in recent years thus inhibiting new supply until rents increase significantly. However, lower yield requirements by developers are eroding the barrier to new construction through increased construction cost. The required yields for development have been dropping, due to the declining yields at which stabilized property sells. This bears watching.

Most of our managers believe that cap rates have bottomed and valuation levels have peaked. Cap rates declined by over 200 basis points in core properties in the last several years. As an example, Exhibit 12 shows the downward progress of office cap rates in recent years in Washington DC. Some back up in cap rates could occur, especially if interest rates increase. The recent trend in cap rates, however has been continuing down. As a prominent example,

some of the properties sold by Blackstone after its acquisition of Equity Office Properties were reportedly priced at a yield below 4%.

In the U.S., leverage has lost most of its power to increase returns, as shown in Exhibit 13. With debt costs at about 6% equaling cap rates on sale, there is no operating leverage left. In the case of the highest-quality core properties, debt costs substantially reduce property yields and operating returns. Conditions overseas are generally more positive due to lower interest rates. In Japan, debt remains a powerful return enhancing investment as borrowing rates remain well below property yields.

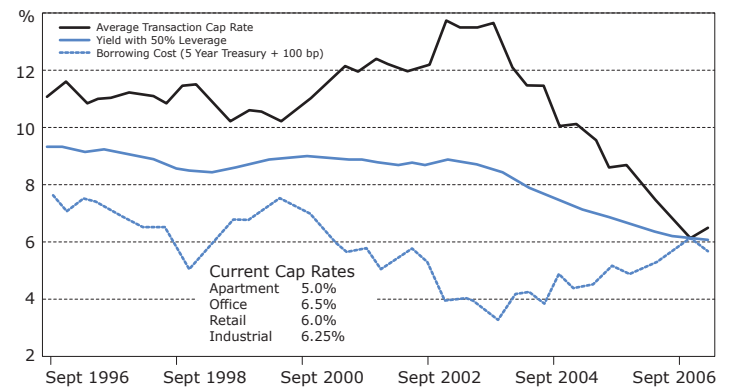
Real estate continues to gain credibility as a mainstream asset class, both in the U. S. and overseas. Globally, this is supported by increasing transparency and more active sale markets as well as the increasing recognition that commercial real estate is a major source of wealth around the world. The 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. On the public side, this trend is assisted by new laws allowing REIT-like structures. These public equity structures enable broader and deeper markets for real estate ownership overseas and free up longtime real estate holdings by owners who wish to diversify their holdings.

Given our view of real estate, many of our managers are "manufacturing" real estate assets to satisfy the appetite of the growing population of investors who desire stable, income-producing, quality real estate properties for investment. Barring an economic reversal, we expect the trend of increasing appetite for real estate investment to continue for a number of years as real estate investments today constitute a very small portion of institutional and individual investment assets. Our managers create these opportunities through buying at a discount to fair value, repositioning a property through releasing, repositioning or redevelopment and through ground-up development itself. Such opportunities exist by virtue of the very property specific and inefficient nature of real estate markets. In our view, the real estate asset class is the least efficient of all of those we invest in.

More specifically, we are pursuing a more concerted effort to increase our clients' investment in Asian real estate. The case for Asian real estate rests importantly on the large unmet need for an upgrade in the quantity and quality of real estate assets throughout Asia. The rationale in an overall sense:

Exhibit 13: The Dwindling Power of Leverage



Source: NCREIF, AEW Research

- Asian populations are fast growing, 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, highquality real estate projects there.

U.S. public markets for REITs have been one of the best performing sectors of U.S. equity markets over the last several years. Despite the appreciation in REITs in recent years, private market values for real estate actually exceed the net asset value of most REITs, leading to the recent spate of acquisitions of REITs by real estate opportunity funds. This valuation gap has led to several large going private acquisitions of REITs.

Private Equity

Although private equity indices are flawed, Venture Economics reported a 16% increase for venture capital funds for the year ended December 31, and a 25% increase for buyout funds. These data are the latest available.

Recent conditions for buyout funds have been unusually good. Corporations in the U.S. and Europe continue to rationalize their businesses and delever by selling off lagging operations. Lending conditions have been extraordinarily easy and the junk bond market is very accepting of low-grade credits, resulting in debt costs for buyout funds at levels far below expected returns for their target acquisitions. The range of market capitalization susceptible to a buyout has increased at the upper end, as some buyout funds have become very large and are amenable to club deals in which several funds, including hedge funds, pool their resources to buy a company. Nine of the ten largest buyouts in U.S. history have occurred in the past two years.

The result has been extraordinarily high short-term returns and a surge in the volume of large leveraged buyouts in the U.S. and overseas. Current conditions have allowed larger LBO firms to purchase an asset, install relatively short term improvements, and then refinance at much higher leverage, or tap the IPO market, to achieve extraordinarily high short-term returns. Increasing standards of corporate governance and the growth of activist investing are likely to continue to provide fairly fertile ground for buyout investing, especially overseas where the need for restructuring is greatest.

The primary issue for buyout funds is likely to be price given very large increases in the amount of investable capital in this field, as the number and size of buyout funds increase and as they are joined by some of the larger hedge funds. Buyout funds raised over \$150 billion in 2006, which translates into nearly \$500 billion in additional buying power when levered. Paradoxically, it may be the very largest buyout funds that succeed most in the near term as valuations of larger companies are now relatively low and only the very largest buyout funds, even together in club deals, can finance the buyout of a major public company.

The degree of leverage continues to climb given low interest rates and very easy lending conditions, including few covenants and long amortization periods. Some LBO funds seem to believe that their debt terms are nearly as valuable an asset as the company they buy. Correspondingly, buyout multiples of cash flow also continue to rise, now in the 8x-9x range or higher for larger, more mature target companies. It should be noted that continued easy lending conditions and low rates are fundamental to the valuations

being paid today and the health of LBO firms.

Venture capital funds raised about \$25 billion in 2006 and deployed about the same amount. Late-stage investing was fairly dominant, a reflection of the ongoing support of existing portfolio companies in additional financing rounds. Healthcare and medical devices were gaining relative to other sectors.

Returns from venture funds are somewhat impeded by the Sarbanes-Oxley legislation, which makes an IPO for a small company daunting. The result has been fewer IPOs and greater time to liquidity. 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. More than ever in this environment, investors are well advised to stay with the top tier venture firms in the U.S. given their competitive advantage in deal access and management of fledgling companies.

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 recently 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 ambit 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 that 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 trend. While a slowdown in the U.S. is well underway, its effects are expected to be moderate and largely offset by growth in the rest of the world.

The bad news is that investment markets remain awash in liquidity and most are priced at or above historical valuation levels. Nothing visible on the horizon appears likely to change these circumstances. The shock generated by

the subprime mortgage debacle has likely come and gone without any lasting change in risk perception. As mentioned earlier, we believe investment conditions could become still riskier and less desirable in the very plausible scenario in which abundant liquidity and declining volatility in many aspects of economic and investment activity reduce risk premia, further elevating investor complacency and leverage.

For risk-conscious investors such as ourselves and our clients, this is an uncomfortable situation, as it is difficult to find returns that justify the risks we perceive. While we would prefer a more conducive world in which to deploy our clients' capital, we cannot change the facts we face. We must simply determine how best to profit from the current environment while remaining very conscious of the risks we take in doing so. Currently, we are focused as follows:

- Given the fact that all asset classes are over-funded, 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.
 - Cash seems more inviting, with short-term taxable rates near 5%. The combination of below normal expected returns from other liquid assets and the fact that those opportunities we find are increasingly illiquid, have made us more tolerant of higher cash balances.
 - 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 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.
 - 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. This is especially attractive in markets overseas where restructuring and rationalization have lagged that of the U.S.
 - Further 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 companies have an opportunity to grow their profits at a rate disproportionate to the U.S. as they restructure and accommodate to the increasing globalization of trade in the pursuit of better profitability.
 - Within foreign stock markets, focus more on the restructuring and rationalizing potential on 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 less liquidity and higher risk, supported by higher potential return.
 - We continue to recommend reduced exposure to broad fixed income markets. Global inflation appears well contained and interest rates should remain stable. Our caution stems from concerns in the credit markets where credit spreads remain very compressed relative to historical norms, providing investors with a very poor risk/reward proposition. As a result, our fixed income solutions are implemented in high-quality securities, which are less subject to capital erosion in the event of widening spreads or major shocks to the credit markets.
 - To the degree possible, build commercial real estate exposure, both in the U.S. and, to an increasing degree, internationally. Operating fundamentals are in an improving phase and real estate continues to be 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 desires. We will focus more on creating opportunities in the growing and still less efficient Asian markets.
 - 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.
 - Expand the traditional concept of private equity to include a broader range of non-marketable investment strategies beyond the classic venture and buyout fund areas. As we have to dig harder to find opportunity in today's world, we are more frequently finding investment opportunities in the often less-liquid seams between the converging worlds of traditional investment management, hedged strategies and private equity.
- We conclude by repeating that the current era could test our convictions, importantly relying on fundamentally sound

valuation. A low return world of investor complacency, higher tolerance for risky assets and high valuations often leads investors to, consciously or unconsciously, adopt a shorter-term, trading focus on risky assets in the search for better return. This is very much the mentality that we see in many hedge funds today and we fear that increasing success of highly risk tolerant strategies will lead to an increasingly complacent, more highly levered and risky investment era, which could persist for a period of years. For as long as it works, such an approach can show attractive returns without apparent undue risk. However, if liquidity dries up or investors become less complacent, the underlying risks are likely to show up, possibly suddenly.

By contrast, 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 continues to develop, 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.
