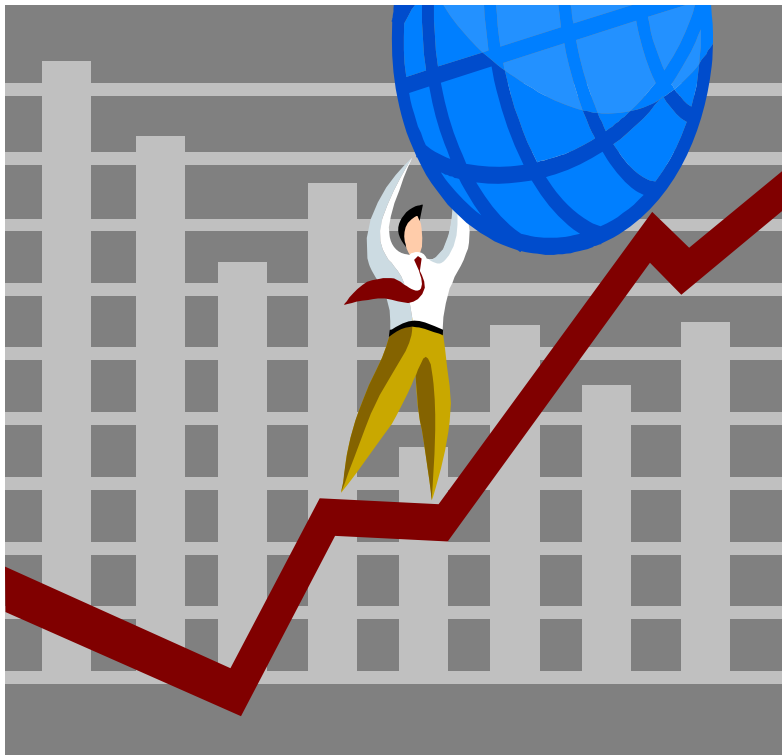


# Lots of Smoke

## 2007 Q2 Quarterly Commentary



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### Lots of Smoke

Over the past two weeks global markets have undergone a second bout of volatility this year. As you know from our 2007 Outlook and our commentary "Is it safe?", we are not surprised and have made portfolio modifications to bolster their resilience. But the question which we naturally can't answer is whether this is just another fleeting scare or something a bit more serious. The problem, today, is that investors have been a bit too trusting.

Back thirty years ago, when I was a freshman at Columbia College, all students were required to take a course called Contemporary Civilization or "CC" for short. (The course is still a requirement today, just like it has been since 1919.) Contemporary Civilization is a two semester course that surveys the philosophy of Western Civilization from the Pre-Socratics of ancient Greece all the way through Marx and Kant. It was brutal. But like every graduate said at the time, I too say that it was probably the best course I ever took.

While I remember some of the themes of the course, one little tidbit that always has stuck with me is that the Greek word Credo means "to place trust in". Or put another way, credit is an extension of trust.

This extension of "trust" has made the modern world so much more bountiful. Credit, together with statistical methods to mitigate risk, has raised people's standard of living more than about any other discovery. Just imagine how complicated life would be if it took hard cash, or worse bartering, to facilitate every transaction.

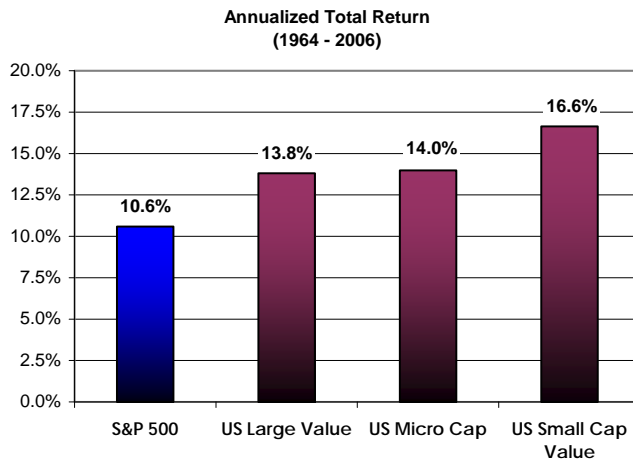
So credit is good. But the problem is that from time to time too much credit gets extended to too many people or to too many business opportunities. This always is a precursor to a credit crunch and usually some nail-biting times in the stock market. The Sub-Prime mortgage debacle is no exception.

How this act plays-out is unclear. The good news today is that risk is spread (diversified) throughout the world's investors in a network structure that is more resilient than the "olden days" when risk was greatly undiversified and centralized in commercial and investment banks, not to mention savings and loan institutions. The bad news is that with increased resiliency is the chance that some market participants are betting much more aggressively and that the risks they are taking are less than transparent to central banks.

What we can say is, right now, there's lots of smoke. Whether there is a real fire is still unknown. In this commentary we will touch on some portfolio changes we have already made over the past year, and also explain why volatility within a diversified portfolio can allow for higher returns.

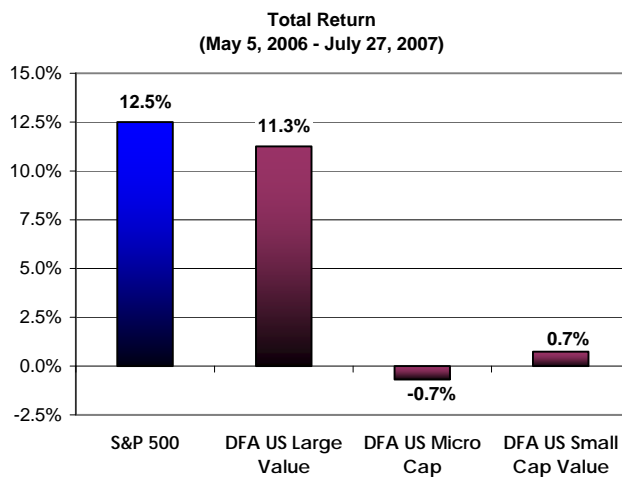
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As you know, we are a Small Cap and Value "shop" – we believe in the premiums of investing in these less liquid asset classes. The benefits of investing in them can be seen in their long-term out-performance over the S&P 500 in the chart on the following page.



But over the past year Frank and I have attempted to position our portfolios for resilience as this business cycle gets long in the tooth. A key theme has been to tactically embrace quality – a major facet of which is our underweighting U.S. Small Cap and Value stocks while overweighting the S&P 500 vis à vis our strategic asset allocation framework. This action needs to be performed nimbly as the chart above points out.

We believe that this tactical tilt is beginning to bear fruit. The chart below shows the returns of the major U.S. asset classes since just before the “panic” of May 2006 when Chairman Bernanke was learning how to communicate with the markets (or as Alan Abelson of Barron’s so eloquently phrased it: “When Ben Burped”).



As a wise woman once told me (who also happens to be a client), “Life is a long game.” But we are heartened, so far, that our embracing of resilience and of quality has not hurt our returns, but helped.

**Bob Henkel**  
Chief Investment Officer

# Disclaimer

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