



On the afternoon of March 7th the trading floor at Bear Stearns, like all trading floors on Wall Street, was alive with riotous laughter, as traders celebrated the discovery of the identity of “Client 9”. However by the morning of March 17th, no one on that trading floor was laughing at all.

The twin crash and burn of New York’s Governor and one of Wall Street’s most venerable institutions will be forever bound by their temporal proximity. As investors look to pick up the pieces after a very difficult 1st quarter, these two seemingly disparate sets of headlines could well be linked for another ironic reason.

If Elliot Spitzer is remembered for anything other than having colossal bad judgment it could be for initiating a series of reform minded attacks on financial institutions which were likely more effective in getting him elected Governor than for producing any meaningful structural changes in the financial system. Through its actions relative to Bear Stearns and other steps to insure liquidity to the markets, the Federal Reserve reassured the world that the U.S. Financial System would not collapse, yet made certain that shareholder liability at the individual company level would not go away. One gets the sense that this could indeed signal an important change in financial risk management at the micro level and investor sentiment at the macro level.

No area of the equity market was spared poor results in the first quarter of the year (save REIT’s, up fractionally – but probably a tough sell back in January). The broad market as measured by the S&P 500 fell by -9.45% with the Dow Jones Industrials a little better at -7.03%. Value fared slightly better than Growth with the Russell 1000 Value Index down by -8.72% and the Russell 1000 Growth Index down by -10.18%. International markets were not immune from the tough environment as the MSCI EAFE Index fell by -8.83% and the MSCI Emerging Markets Index was down -10.98%.

As you’ll no doubt recall, back in January we made the statement that the “premium available to investors for holding equity is higher than it has been in some time”. As we’ve continued to run our models, we are still of that mind and will continue to hold equity above our mid point. Our models seek to view the forward risk premium by measuring valuation from both an earnings and asset perspective and then view these valuations within the context of the economic and interest rate environment.

Irrational fear and imperfect liquidity can be nasty features of the markets in the short term. However looking at the very positive results achieved in the months immediately following “credit crisis” environments (such as 1990 and 1998) suggests that investors will be paid handsomely for taking equity risk when the “crisis” abates. It is not the nature of our process to try and predict the market bottom, however the fall of Bear Stearns seems to have the markings of a crisis ending milepost.

As far as the fixed income exposure in our portfolios, we’ve typically been fairly conservative, keeping the duration short and the credit quality high. In January, we



augmented our all Treasury ETF exposure with limited exposure to short duration corporate credit. While this didn't really help or hurt us much, we are remaining in this mode, and feel that we will capture some premium from the wider than normal credit spread as we go through the next quarter. Despite a yield curve which is starting to look more "normal", we are remaining in our short duration positions. We will under unusual circumstances move the duration from short to more intermediate, however we are not doing that at this time. Philosophically we view the fixed income portion of our portfolios as primarily a volatility dampening instrument, which enables us to more aggressively seek alpha in the size and style equity selection area.

During the 1st quarter our equity size and style profile tended towards Larger Caps and a little bit more Growth than Value, with the capitalization over-weight being the more heavy component. This produced something of a "flight to quality" effect in the portfolios, to good relative result. At this time we are moving the portfolios more to Smaller Caps and more into Value oriented investments. Our models rank the different size and style categories by balancing valuation oriented metrics, earnings oriented metrics and momentum oriented metrics. The current move can be seen as being a bit contrarian or to put it another way, the valuation oriented signals in our model seem to be speaking the most loudly and the Small Cap Value area is the best place to find attractive valuations. At the start of the first quarter we moved the International position in the portfolio out of the Emerging Markets area into more Developed Markets, particularly Europe. At this time we are continuing with this approach.