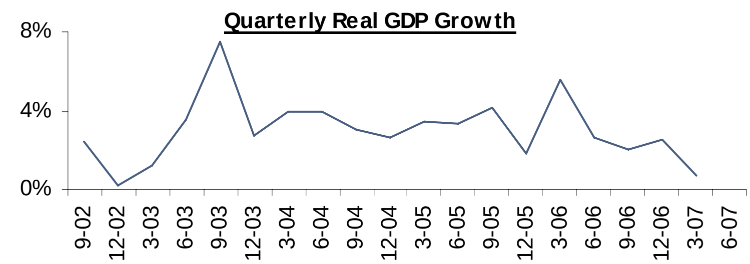
Your Quarterly Update on the Financial Markets
June 30, 2007

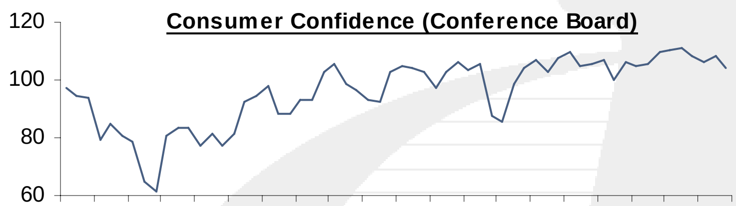
2nd Quarter

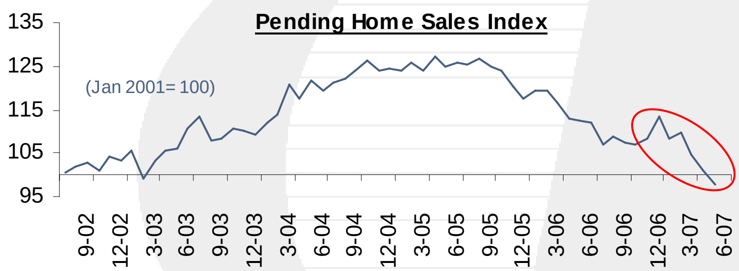
MARKET Recap

The Economy: *"Bonds Bow to Crazed Consumers"*



Growth eased in the first quarter of 2007, with GDP increasing at a 0.7% annual rate. Real personal consumption expenditures remained very strong, increasing 4.2% for the quarter, a pace equal to the 4th quarter of 2006. The spending mix changed however, with increases in nonresidential nondurable goods, computer equipment & software, and motor vehicles. Residential fixed investment decreased 15.8%, compared to a decrease of 19.8% in the previous quarter. Corporate spending remained weak, with business equipment purchases slowing to the lowest pace in more than four years. Leading indicators of business activity improved in the second quarter; most economists expect second quarter growth to come in firm, with a consensus forecast of 2.9%. Consequently the Fed did not reduce interest rates at their June meeting, and adopted a somewhat hawkish stance in their comments.





Through May personal consumption expenditures continued to increase at a pace that outstrips personal income, despite a widening and deepening contraction in home prices, rising mortgage rates, and tightening standards for lending. Personal savings fell to a negative $140 billion in May, or -1.4% of disposable personal income.

Negative personal savings must, by definition, be financed by liquidating assets or increasing debt levels. Increasing debt levels have been supported by low interest rates and increasing home prices, two conditions that no longer hold. After a brief respite in the first quarter, existing home sales fell by 2.3% in April and 0.3% in May. Generating more concern, the Pending Home Sales Index published by the National Association of Realtors declined 3.5% in May to levels not seen since the Iraq invasion began. This index measures sales as of when a contract is signed, typically 1-2 months prior to closing, and as such is a leading indicator of actual home sales.

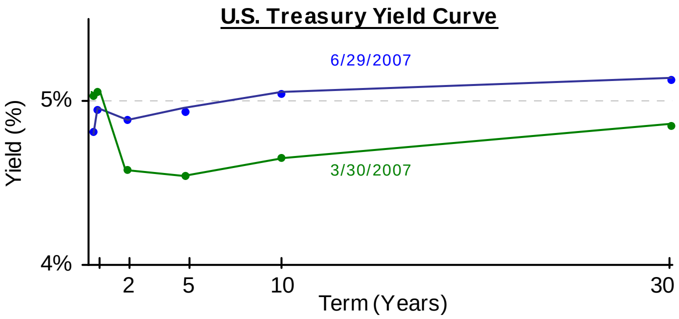
Yet despite contraction in their principal funding source, consumers seem to be unaware or in denial. Unlike the last period of home sale slowness, this contraction is accompanied by strong positive consumer sentiment. A recently published survey of homeowners by The Boston Consulting Group suggests that a majority (55%) of homeowners are confident the value of their homes increased over the past year. Further, 74% of those surveyed said they were confident that they could sell their home within six months, at the price they believe the home is worth.

The U.S. Bond Market

Bond Indices - Total Return	2Q07
Lehman Aggregate	-0.52%
Lehman Interm. Gov't	0.00%
Lehman Long Gov't	-1.98%
Lehman Interm. Credit	-0.40%
Lehman Long Credit	-1.71%
Lehman High Yield	0.22%

The Federal Open Market Committee met on May 9 and June 27; after each meeting the federal funds rate remained at 5.25%, extending inaction on rates to a full year. Statements released after each meeting noted that economic growth "appears to have been moderate during the first half of this year, despite the ongoing adjustment in the housing sector," and that "a sustained moderation in inflation pressures has yet to be convincingly demonstrated." After both meetings, the Committee's statement identified the risk that inflation will fail to moderate as their predominant policy concern. We believe the central bank recognizes that, while consumer spending may and should moderate, the timing of the long-awaited pullback cannot be predicted; rather, consumers will probably continue to spend as long as money is available. Policy must therefore be focused on containing inflation in the face of robust spending.

The bond market also seemed to give up the fight, and re-priced itself in a rather dramatic fashion. The yield curve shifted and lost its long-standing "inverted" shape, which has generally been predictive of slowness. Bond yields ended the second quarter of 2007 up 30 to 40 basis points across the curve except for the shortest durations. Note that the "bet" on continued economic growth remains guarded – by historical standards, the 25 basis point gap between the 2- and 30-year yields is relatively small. With yields ending the quarter higher, prices on bonds, and returns on most of the bond indices, were down. In a June 7 statement, PIMCO manager Bill Gross commented, "After 25 years of being a bull market manager to all of a sudden become a bear market manager, although mildly so in terms of higher interest rates over the next three to five years, is sort of a major shift."



Source: Bloomberg LP

Last quarter we speculated on the potential far-reaching effects of increased mortgage defaults and problems in the sub-prime market. In the final month of the second quarter, Bear Stearns was at the center of a Wall Street object lesson when two hedge funds at the firm nearly collapsed. The funds held more than $20 billion of investments and ran into trouble by borrowing heavily to invest in CDOs (collateralized debt obligations), investment vehicles that hold sub-prime mortgages. The funds lost over 20% of their value, and in reaction, Merrill Lynch (one of the hedge funds' creditors) seized $800 million of collateral for auction. Bear Stearns lent $1.6 billion to salvage the funds, but the situation sent a chill down Wall Street that a forced liquidation would set off a wide-scale re-pricing of mortgage-backed bonds.

Spreads widened modestly in the second quarter, but the damage to returns on investment-grade and high-yield debt was relatively small. The impact of rising mortgage defaults is moving very slowly through the CDO structures, many of which are not efficiently priced. As the market recognizes the greater risk, it is likely that the market will require higher yields in compensation; consequently, our short-term outlook is for additional spread widening.

The U.S. Stock Market

U.S. equity markets performed well for the quarter, but continued to exhibit a high level of volatility; the Dow had 12 days with triple digit gains or losses, more than half of them in June. Fallout from the first quarter sub-prime mortgage meltdown hit U.S. markets again late in the second quarter as mounting concerns over the breadth of the problem and Bear Stearns' hedge fund exposure to sub-prime loans drove multiple sectors down for June.

The broad markets finished the quarter with the Dow, S&P 500 and the NASDAQ up 8.5%, 6.3% and 7.5%, respectively. Growth issues outperformed their value peers across all capitalization sectors and large-cap issues outperformed mid- and small-caps. Energy and technology issues were the star performers driven by higher oil prices and expectations for the highly touted release of Apple's iPhone. The utilities sector, last quarter's defensive play, was the only sector to finish in the red. In addition to the impact of rising interest rates on returns, regulated utilities have had difficulty in passing along increasing energy costs to consumers. The financial sector eked out a positive return, but also had a rough quarter due to sub-prime exposure and a continued decline in REIT stocks.

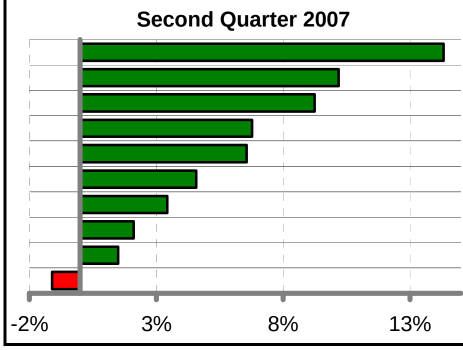
Stock Indices - Total Return

	2Q 07		2Q 07
Largecap Stocks		**Midcap Stocks**	
S&P 500	6.28%	S&P Midcap 400	5.84%
Russell 1000	5.90%	Russell Midcap	5.30%
Growth	6.86%	Growth	6.74%
Value	4.93%	Value	3.65%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	7.50%	S&P Smallcap 600	5.15%
DJ Wilshire 5000	6.07%	Russell 2000	4.42%
		Growth	6.69%
		Value	2.30%

Deal-making in the U.S. topped $1 trillion dollars in the first half of the year; although the second quarter closed with investors showing concern that the buyout boom may be losing steam. Shares of Blackstone Group, which went public with a large IPO during the second quarter, fell below their offer price of $31 as the quarter closed and a unit of Royal Ahold, a Dutch Supermarket Company, postponed a bond sale which was to be used to finance an equity buyout. A number of other postponed or canceled deals may be signaling that investors are turning more cautious. Resistance to private equity deals seems to be correlated to higher interest rates and tougher lending terms. According to Thomson Financial, seven deals were reported on Monday, June 25th, down from 43 and 84 the prior two Mondays. See this quarter's *Focus* article for more coverage of private equity and deal-making.

Corporate profits are expected to be weaker than in the first quarter. According to S&P, corporate earnings are expected to grow just 5.7% in the second quarter. It is unclear whether a slower growth trend is emerging. However, up until the first quarter the S&P 500 had experienced 14 consecutive quarters of double digit earnings growth. The ultimate impact of the housing slowdown, sub-prime scandal, rising rates and global geopolitical events on the equity market is still unknown, but judging by June's performance we may be in for a bumpy ride.

S&P 500 Economic Group Components - Total Return



Sector	2Q07
Energy	14.32%
Information Technology	10.18%
Industrials	9.24%
Telecom Services	6.78%
Materials	6.56%
Health Care	4.57%
Consumer Discretionary	3.43%
Consumer Staples	2.11%
Financials	1.49%
Utilities	-1.11%

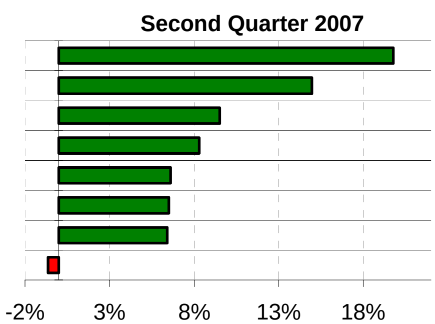
Source: Standard & Poor's

Overseas Markets

Global market performance picked up the pace in the second quarter after some moderation at the start of the year. Most major developed markets and emerging markets finished ahead of U.S. domestic markets with Latin America leading the way at a scorching pace.

As expected, the European Central Bank (ECB) held its key interest rate at 3.75% in mid-May, continuing a gradual path of increasing rates in response to a growing economy and expanding money supply. The ECB's president, Jean-Claude Trichet, signaled that a rate hike would come in June, stating the bank needs to act with "strong vigilance." Interestingly, whenever Trichet has uttered "strong vigilance," the central bank has increased its base rate by a quarter point; holding true to form, they did so on June 13th. Surging money supply is cause for concern to policymakers as the 10.9% growth rate in March was well over the 4.5% target. The European Union lifted its growth forecast for Germany to 2.5% in 2007, up from a prior target of 1.8%. Strong demand for German products, particularly from Asia, is one of the main sources of strong growth. Domestic demand for machinery and equipment has also been a contributor. The MSCI Germany Index was up 16.2% for the quarter. In France, the industry business climate is said to be the best in over six years according to the monthly survey by the French government statistics office INSEE. The business climate index stood at 111 in April, 11% above its long-run average. Foreign orders have had a positive effect for much of the last year, but until recently had been more than offset by domestic weakness. It appears domestic markets are improving enough to permit overall growth, rather than completely offsetting the foreign component. The MSCI France Index was up 15.6%.

Net Total Return of Selected MSCI Regional Indices



Region	2Q07
Latin America	19.76%
Emerging Markets	14.96%
Pacific ex Japan	9.50%
Europe	8.31%
North America	6.61%
World Index	6.51%
EAFE	6.40%
Japan	-0.64%

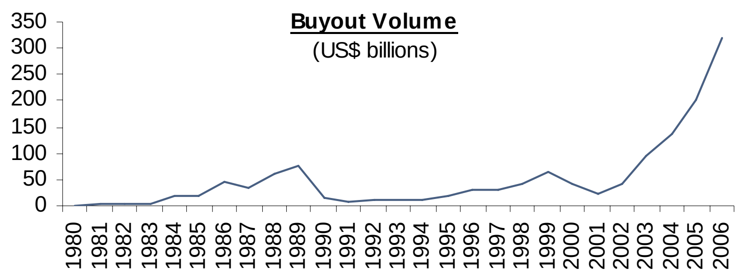
In Japan growth remains elusive. Industrial production surprised many forecasters, falling 0.6% in March from February and slowing to just 1.6% above March 2006, after gaining 3.1% in February and 4.8% last year. The losses were widespread across equipment and materials. Household living expenditures also had trouble holding gains and sank by 1.4% in March. Unemployment has held steady at 4.0% for five consecutive months, the lowest rate since the winter of 1998. But most troubling has been the government's declaration that CPI has started to weaken again possibly leading to a halting of expected rate increases. The MSCI Japan Index was down 0.6%.

China again experienced a strong sell-off based on rumors of government intervention to slow runaway growth and speculation. On April 19th the benchmark Shanghai Composite Index fell 4.9%. This was followed by drops of 6.5% on May 30th and 8.3% on June 4th. China's economy grew at a faster-than-expected pace in the first quarter and inflation rose to 3.3% in March, above the 3% growth target range. GDP expanded 11.1% in the March quarter, surpassing consensus expectations of 10.3% growth. The torrid pace of growth continued in May as annualized inflation rose a higher-than-expected 3.4% prompting the Central Bank to raise interest rates 0.27% to 3.06%. The Central Bank also increased the yuan's trading band versus the U.S. dollar to ±0.5% per day from 0.3%. Consensus forecasts call for a number of 0.27% increases throughout the remainder of the year as the Central Bank tries to rein in the explosive growth. Despite all this, the MSCI China Index was up 24.4%.

Latin American markets were tops in global market performance again. In Brazil first quarter GDP grew at 3.1%, down from 4.3% the year earlier. This represents a modest slowing from recent performance, as the 3.1% follows 12 quarters that averaged 4.4%. Fixed investment and exports were the main drivers of growth. Investment expanded at an 8.9% rate up from 7.5% in Q4. Exports swung from a decrease to an increase of 4.7% in the first quarter and appear to be moderating from a period of rapid expansion that peaked late in 2006. A strengthening currency is starting to be felt in export markets as some consolidation is occurring after a prolonged period of growth. Imports surged ahead at a 17.5% annual rate in the first quarter, up almost 20% versus the same period in 2006. Consumer spending was up 3.7% in Q1, but had risen considerably more in prior quarters, putting it up 6.0% over the past year. The MSCI Brazil Index was up 23.8% for the quarter. In Argentina the central bank raised its forecast for economic growth this year to about 8 percent from a previous forecast of more than 7.4 percent. Increased consumer spending is helping to drive the expansion and exports are expected to reach $52 billion this year. South America's second-largest economy has grown at an annual pace of at least 8.5 percent in each of the past four years, helping reduce the country's unemployment rate and prompting the increased consumer spending. The MSCI Argentina Index was up 6.8%.

Focus On: *Private Equity – What's the Deal?*

Listen to any financial news show or pick up the business section of a paper, and you are bound to find a story about private equity. Deal after deal makes headlines. In May, auto-giant Chrysler announced plans for Cerberus Capital Management (a private equity firm) to assume a controlling interest of 80% of the company. Industry experts hailed the deal as a groundbreaking step and proof that private equity firms were now seeing possibilities in areas that had once been considered out of their reach. So just what is all the fuss about? What is making private equity deals so hot right now? To answer these questions, we have to start by taking a look at how U.S. private equity transactions have evolved.



Private Equity Past

Private equity is a general investment class in the broader category of non-publicly traded securities (often referred to as alternative investments). Typical alternatives include real estate, commodities (e.g., gold, timber, etc.), hedge funds, as well as private equity. Private equity deals can be divided into two main groups: venture capital transactions, the capital funding of early-stage companies; and leveraged buyouts, the purchase of established companies through a combination of debt and equity. It's this last category that has experienced tremendous growth.

While particularly hot right now, leveraged buyouts have been around for decades. The leveraged buyout strategy of the 1970's and early 1980's was simple: find stable companies with borrowing capacity and acquire them for modest purchase prices financed by borrowed funds. In a market where public stocks were cheap (relative to today), low purchase prices meant that even in a high interest rate environment, debt could be paid off quickly.

By the mid 1980's institutional investors were increasingly drawn to the buyout sector as laws restricting pension plans from investing in private partnerships were relaxed and the development of high-yield bonds offered new capital structures (e.g., senior subordinated notes, subordinated notes with warrants, etc.) with attractive returns to the market. In this era, buyout strategies focused less on the bargain hunting of the past and more on financial engineering to create maximum leverage. Problems occurred with the onset of a recession in 1990 – 1991, and default rates on high-yield bonds increased. Suddenly investors saw that even the high returns and equity stakes structured into the deals were not sufficient compensation for the risk they were taking.

The 1990's saw a rationalization in the buyout market. Leverage ratios in deals dropped significantly. At the same time, the rise in the value of the stock market meant that purchase prices for target companies increased. Buyout strategies experienced a return to the basics of investing: seek good companies with good strategies and good balance sheets.

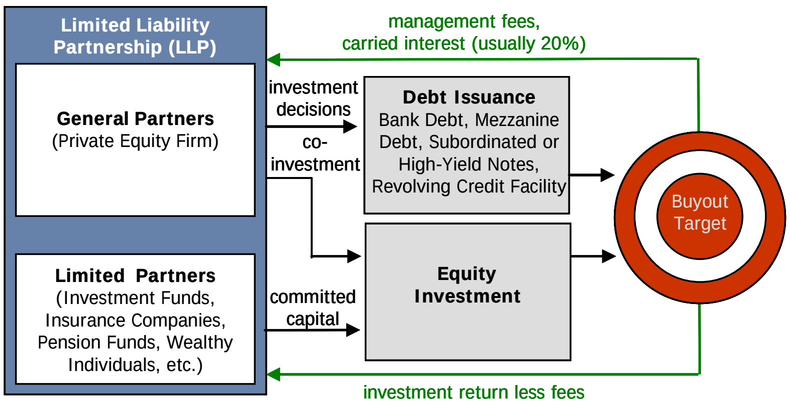
Private Equity Present

In today's private equity market, stock prices and, accordingly, buyout purchase prices are high. Investors have demonstrated a renewed acceptance of higher leverage multiples. The number of buyout firms has increased making the competition for deals fierce. In 2006, a Wall Street Journal editorial characterized private equity as "booming," with the handful of private equity firms managing a few billion dollars 15 years ago growing to over 250 firms controlling $800 billion in capital today. The bargain-hunting tactics of the 1970's and financial engineering strategies of the 1980's are no longer effective. Buyout firms today tend to focus on improving the operating performance of their buyout targets through rigorous cost-cutting or other operational controls or the rationalization of the business model, creating value by creating a better company.

Not surprisingly, private equity targets share some characteristics. The stock price performance of firms that go private is typically worse than industry peers during the one, two, and three years before their going private transactions were announced. Their average return on equity (ROE) is also significantly lower than industry peers. Finally, private equity targets generally have more cash as a percentage of assets than industry peers. These traits can all be seen as signals that a firm needs operating improvements – improvements more likely to be achieved in a private firm.

Private equity activity grabbed headlines with its 1Q 2007 figure of $7.1 billion invested. This was the highest quarterly dollar amount invested since 4Q 2001. (Source: The Money Tree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Financial) What is driving assets to private equity firms? Current attitudes in the public equity market account for part of it. In response to the tech-fueled bubble popping in 2000 - 2001, investors began to exhibit more of a short-term focus along with an increased risk aversion. Today's private equity funds with their focus on improving the operating performance of the companies they buy, plays perfectly to this attitude offering investors an attractive alternative to the public markets. Conditions in the fixed income market also enhanced the attractiveness of private equity investing. The low interest rates and historically tight credit spreads we have experienced are conducive to floating the debt necessary to fund a buyout.

Typcial LBO Structure



From an investor perspective, private equity can be a difficult asset class. Investing in this non-public space means giving up transparency, liquidity, and the protections they offer. Investors are institutions or high-net-worth individuals. Currently, over 50% of investments in private equity come from public and private pension funds.

But private equity still has its attractions. Although the 60% - 100% returns typical of the leveraged buyout deals of the 1970's are clearly unachievable today, by all accounts today's buyouts still consistently out-perform the public equity market. But perhaps more importantly, the interests of private equity firms and private equity investors are significantly more aligned than those of managers and investors in the public markets, with the general partners of private equity funds compensated both through a management fee and a performance fee (i.e., a percentage of the profits).

Private Equity Future

Some see the growth in private equity and going-private transactions as a signal of concern over the costs of going or remaining public in the U.S. markets. Between 2001 and 2006, the number of private-equity backed acquisitions has dwarfed the number of private-equity backed IPOs. (Source: Thomson Financial & National Venture Capital Associates) But while the U.S. public market may be becoming less attractive to companies, Congress is considering proposals to end a tax break that may make private equity less attractive to its general partners. Proposals have been made both to increase taxes on private equity firms that go public (covering only a handful of firms) as well as on private equity and hedge fund operators in general. The proposals center on eliminating a longstanding practice of allowing these firms to pay a lower, capital gains rate of 15% percent instead of the ordinary corporate income tax rate of 35% on their performance fees, which typically represent most of their annual income. While the private equity industry argues that the risk involved in their transactions justifies the lower tax rate, critics counter that the fees are effectively bonuses because private equity firms have little, if any, of their own money at stake.

The debate on the private equity tax rate may be a symptom of a larger, and more troubling, trend for private equity firms. Like many of the great alpha-producers in the past, private equity may be facing the challenge of a market increasingly approaching efficiency. As the number of private equity firms increases, partnership talent as well as the pool of attractive buyout candidates gets spread more thinly making good deals harder to find. Further, public companies are themselves increasingly employing the disciplines private equity firms impose after buyouts, narrowing the performance gap. With these trends, it's hard to argue that the private equity market is not becoming more efficient. And in that case, we can expect strategic advantages to be lost and risk-adjusted returns to decay to the median.

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