

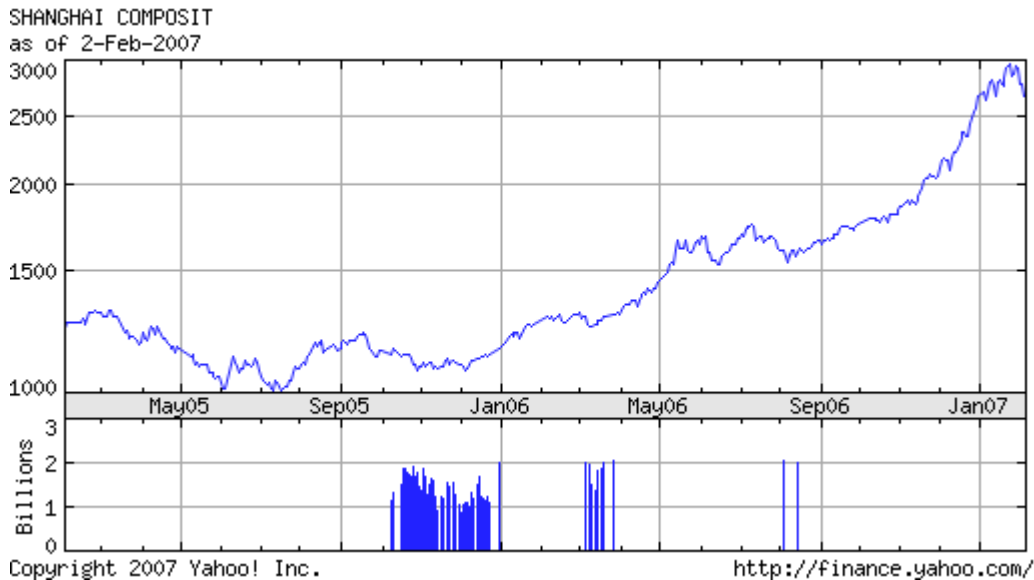


February, 2007

Bring the Boats Closer to Shore

I had a real tough time writing this piece. It wasn't about procrastination or being too busy. Examining various data points, investors today can build a negative or positive case for the domestic economy and the markets. For those of you who know us well, we frequently talk about our inclination to employ "Old Pilots" as money managers. (There are old pilots and bold pilots, but no old bold pilots.) The Old Pilot has flown through a number of investment storms. He or she knows what to do when the going gets tough. Many Old Pilots have a sixth sense for knowing when trouble is on the horizon. They prepare well for potential turbulence. You want them in your cockpit.

I like to talk to the Old Pilots before I sit down to write a strategy piece. Most Old Pilots don't waffle. They have strong convictions about their investment views. Speaking with 10-15 of them can give one a pretty good feel for where things are going and where the land mines may lie. The consensus view is that markets may be getting ahead of themselves. Investment bubbles are continuing to form in various pockets of the world. The unprecedented rise of the Shanghai Stock Exchange Composite Index is an example of how a world awash in liquidity can create mispriced assets. The chart appears below.



The List

As I sat down to write this strategy piece, I made a list of positives and negatives for the economy and markets. Some items on the list were short-term in nature and others were addressing longer term issues. Here are the positives and negatives as we view them today.

Positives

The world is awash in liquidity, pushing asset prices higher.

Corporate America has never been stronger. Balance sheets are underleveraged. Earnings continue to be robust.

Dividends on common stock are rising at a rapid pace. Stock repurchase plans are ubiquitous.

Private equity firms have massive war chests. Large buyouts are removing equity from the marketplace. It is not being replenished via the IPO market.

There is a sense of quiet complacency regarding the equity markets. Volatility, as measured by the VIX, is close to 10-year lows.

Lower interest rates, exceedingly narrow credit spreads and a flat yield curve make it easy to borrow “cheap” money.

The Fed is being well managed by Ben Bernanke.

Negatives

There is too much liquidity chasing too few opportunities. Asset prices in some categories are unsustainable.

The average American is spending more than they are saving.

The housing markets have cooled and may decline further. Real capital destruction is taking place in some parts of the country.

Buyouts of public companies are roiling the debt markets. What is investment grade one day becomes junk the next as debt is piled onto the balance sheet of the acquired company.

Volatility helps some managers achieve returns.

Households piled on leverage in the form of “teaser” mortgages and home equity loans. Default rates, particularly on sub-prime mortgages, are beginning to rise.

Private equity firms are piling leverage onto their buyout targets, making these companies more vulnerable to an economic slowdown or higher interest rates.

Hank Paulson is doing a superb job as Treasury Secretary. He is attracting outstanding talent to Washington.

Margin loans are approaching levels seen just prior to the last stock market crash. Please see the chart below.

Margin Loans Are Reaching All-Time Highs



We're Having a Party...

Great parties last longer than expected. Intuitively, people know it's probably time to go but it is hard to leave when everyone is having so much fun. Staying too long, however, has its consequences – most of them not so good. 2006 represented a great investment party. Liquidity was the punchbowl. Someone pulled the fire alarm in May, but we all came back into the building and had a great time. Perhaps it is time to think about leaving. At the least, we should be plotting a safe route home. Let's examine why.

Returns of Popular Averages in 2006

Domestic

S&P 500	15.80%
NASDAQ	9.52%
Russell 2000 Growth	13.35%
Russell 2000 Value	23.48%
Lehman Aggregate Bond	4.33%
Lehman Aggregate Tax-Exempt Bond	3.34%

International

EAFE (Global Developed Markets)	23.47%
FTSE (UK)	10.71%
DAX (Germany)	21.98%
MSCI Emerging Market Equities	29.18%
MSCI Asia Ex Japan	30.14%
Nikkei 225 (Japan)	6.92%

Global Liquidity – Friend or Foe?

Let's think back to last May. The Fed, The Bank of Japan and their major counterparts removed liquidity from the banking system in a lightning quick series of events causing major dislocation in global equity markets. Brian Westbury's editorial in the June 7 edition of *The Wall Street Journal* summarized the situation well: "Monetary policy was overly accommodative for too long. Weaning investors, home builders, hedge funds, and proprietary trading desks from 50-year low interest rates is like forcing them to quit smoking: It's good for the health of the economy, but it hurts and they are complaining loudly".

Interest rates were too low for too long. In late 2000 and throughout 2001, the U.S. Federal Reserve Bank, led by Alan Greenspan, was worried that the American economy was headed into a deflationary environment. Deflation, as opposed to inflation, is marked by a shrinking economy and the destruction of capital by falling asset prices. The Federal Funds Target Rate was reduced from 6 ½ % to 1% over two years. One of the tools the Fed uses to reduce rates is the "creation" of money in the banking system. To simplify the explanation, the Fed loans more money to banks all over the country at lower and lower rates. The banks then lend that money to individuals in the form of mortgages, home equity loans, or lines of credit. Corporations borrow for capital expenditures or acquisitions. Financial institutions borrow to leverage their balance sheets. All of these entities were willing to accept more risk because the absolute level of interest rates was so low. Money was "inexpensive" due to low interest rates and easy to borrow because there was excess capital in the system.

As policy makers were convinced that the deflation scare was over, they began raising rates, removing some of the excess liquidity from the economy. This policy was

not isolated to America. Japanese and European central banks also started draining liquidity from their banking systems. The first crescendo took place in early May of 2006. Those who had borrowed cheap money raced to sell liquid assets. The impact was devastating.

Lest we not forget, the following table reviews the performance of a number of major equity indices from May 1 through June 12, 2006.

Domestic

S&P 500	-5.42%
NASDAQ	-9.96%
Russell 2000 Growth	-12.74%
Russell 2000 Value	-8.27%

International

EAFE (Global Developed Markets)	-9.29%
FTSE (UK)	-5.50%
DAX (Germany)	-10.46%
MSCI Emerging Market Equities	-17.40%
MSCI Asia Ex Japan	-11.40%
Nikkei 225 (Japan)	-16.95%

The Fed's Dilemma

The Fed did not finish the job of extracting liquidity from the monetary system last May. The gut-wrenching reaction in the markets caused the central banks to back off. They must continue the process. The dilemma is how to reign in liquidity (and speculation) without setting off another round of capital destruction. So far, Bernanke and his team have done a great job of managing the problem. The hope is that we'll experience a soft landing. Part of the Fed's problem is that our domestic asset bubbles have already started to pop. The housing market has cooled considerably and energy prices have fallen and stabilized. The threat is more global in nature, thus more difficult to control. We're concerned about the ripple effect of dislocations in emerging markets (both equity and fixed income), junk bonds, and the structured derivatives markets. If there is a major decline looming on the horizon, we suspect that it will be a "gap" event where bids disappear from illiquid and liquid securities alike. This is far more dangerous than a slow steady decline.

How Should Portfolios Be Positioned?

One of our Old Pilots passed along a quote to me from Charley Ellis, the chairman of the Yale Corporation Investment Committee.

“Yale’s...remarkable success is defense, defense, defense...if investors could just eliminate their larger losses, the good results would take care of themselves...we remind ourselves of the great advantage of staying out of trouble.”

Most of our clients already have their boats fairly close to shore. Those that don’t are being urged to allow us to rebalance to a more conservative posture. While each of our clients has different goals and objectives, there are a number of major themes in the construction of our customized multi-manager portfolios. They are listed in no particular order:

- Long /Short Equity will continue to provide the best risk-adjusted returns for investors;
- Strategies that employ large amounts of leverage will be at the center of capital destruction in any meaningful downturn;
- The long-term growth rate on domestic equities will continue to be roughly 10% over time. While not overvalued by traditional measures, we are overdue for a correction.
- Large cap will outperform small and mid-cap over the next few years;
- Dividend yield and dividend growth will be important characteristics to equity returns;
- International economies will grow faster than the US economy going forward;
- While the buying power of the US consumer is waning, global consumers in Japan and emerging economies will pick up the slack;
- Companies with true global franchises (GE, Altria, United Technologies, Microsoft, Nestle, Unilever, Heineken, etc.) will outperform companies with a narrow domestic orientation. It is becoming more difficult to separate domestic from international equity management because large global franchise companies can be headquartered anywhere;
- Emerging market equities are currently overvalued;
- The current low volatility makes hedging extremely inexpensive. Explore disaster insurance for your portfolio.
- Volatility will rise. Seek out managers that will benefit from more volatile markets.
- The recent fall in commodity prices may create a reasonable opportunity to add hard assets to a portfolio. Exposure to oil, gold, and the Dow Jones or Goldman Sachs Commodity Index can be created through Exchange Traded Funds (ETFs). Hard assets will hedge a portfolio against inflation and geopolitical risk.

- Fixed income, while an important risk mitigant and portfolio diversifier, will offer disappointing returns over the near-term. Credit spreads do not reward investors for default risk. The flat yield curve does not compensate for duration risk. Some component of international fixed income should be in the portfolio.
- Build a diversified portfolio of managers and styles with low correlations to each other. This will help to reduce volatility and drawdown risk.
- Hire Old Pilots.

Buy

Long/Short Equity
 Volatility
 Hedges (Disaster Insurance)
 Large Cap International Equities
 Global Equities with High Dividends
 and Cross-Border Franchises
 Commodity Oriented ETFs
 Japanese Equities

Sell

Junk Bonds
 Emerging Market Equity
 Emerging Market Debt
 Mega Cap Private Equity
 Contemporary and Modern Art

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