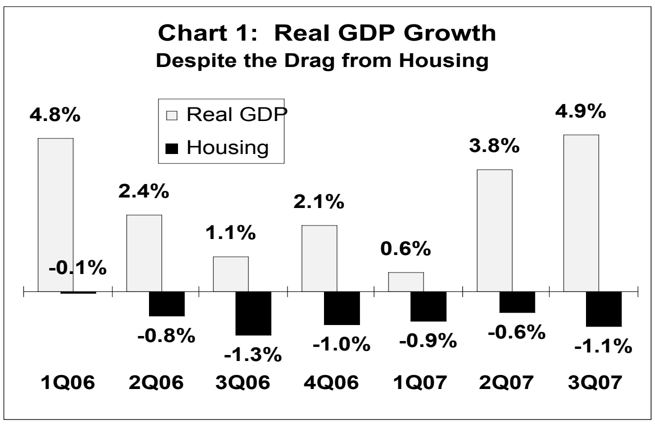
Investment Update
Year-End 2007

Economy

At the end of 2006 it was clear that the housing market was slowing. Nationally, average home prices had topped out in 2005 and the slow-down in building activity had been acting as a drag on the economy for most of the year. But at the time, it seemed that the brunt of the slow-down would be borne by the construction-related industries. We did expect banks' earnings to be under some pressure because of lower demand for new mortgage loans and that consumers would spend less freely, but that the economy would continue to grow.



Parts of that assessment were too optimistic. A year later, average home prices have fallen 5-10% from the 2005 peak and do not appear to have found a bottom yet, and the rate of new home construction is half of what it was in recent years. Banks and institutional investors around the world have incurred huge losses on mortgage lending and related investments. Unfortunately, we expect that there will be additional losses, and there is a great deal of uncertainty as to the extent to which the ongoing fallout from the sub-prime mortgage mess will affect the financial sector and the broader domestic and global economies.

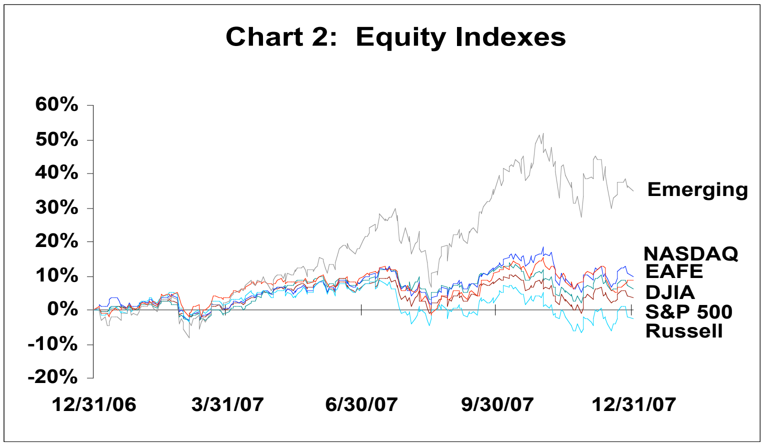
While the housing market has been worse than we expected and the losses in the financial sector have been surprisingly large, we were right about the broader economy. The good news is that the global economy has been growing strongly, powered by decent growth in the developed world and even higher growth in the developing world. Despite the weak housing market, global credit market disruptions, and $90/barrel oil, third quarter real growth of 4.9% in the U.S. was the highest in more than 3 years. Rising real incomes and good employment prospects have supported consumer spending, while a declining dollar has helped exports to boom. Some of the weakness in residential construction has been offset by strength in commercial construction.

With this economic momentum, and with corporate balance sheets in good position to weather the current credit crunch, we expect that growth will continue. Although it is likely that growth over the next few quarters will be below the pace of the third quarter and growth for all of 2007 will likely drop into the 2.5–3.0% range due to the significant credit market disruptions. We do not expect a recession in 2008, although the odds of a recession have probably increased somewhat since our last update.

As long as markets are allowed to function, and the pain from the sub-prime mess is primarily felt by those who borrowed too much and by those who lent recklessly, the global economy will get through this rough patch. At least for the time being, taxpayers are not being asked to bail out borrowers or lenders. Some lenders are voluntarily renegotiating loans to struggling homeowners. Some shaky financial institutions have been able to attract large capital investments by private investors and sovereign wealth funds, albeit on very expensive terms. Leaders of many of the troubled institutions have been replaced. These are all healthy developments.

Equity Markets

During the fourth quarter the equity markets were even more volatile than during the third, and the approximately 10% slides in many of the major indexes in October and November certainly felt like corrections. Much of this added volatility can be attributed to turmoil in the credit markets.



Despite the recent high volatility, most of the major indexes ended the year with modest gains. Overseas markets, especially the emerging markets, again generally outperformed the U.S. markets and larger-company stocks tended to do better than smaller stocks.

Overseas investments have become increasingly popular, as ways to diversify beyond the U.S. markets and to possibly earn better returns given the higher growth potential of some foreign economies. Our equity portfolios have used targeted foreign investments for some time, but the primary source of overseas exposure that most equity portfolios have is from the high and growing international exposure of most large U.S. companies. Standard & Poors estimates that in 2006 the companies in the S&P 500 Index derived approximately 45% of their revenues from outside the U.S.

For 2007 the best sector to invest in was Energy (+32%), followed by Materials (+20%), Utilities (+16%) and Information Technology (+15%). There were only two sectors with negative returns for the year, and portfolios that were under-weighted in one or both of these sectors stood a good chance of outperforming the overall market. Financials (-21%) were the weakest group by a wide margin, and Consumer Discretionary stocks were also poor performers (-14%).

Table I

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	2007
DowJones Industrial	-0.9%	8.6%	3.6%	-4.6%	6.4%
S&P 500	0.2%	5.8%	1.5%	-3.8%	3.5%
NASDAQ Composite	0.3%	7.5%	3.7%	-1.8%	9.8%
Russell 2000	1.7%	4.0%	-3.3%	-4.9%	-2.7%
MSCI EAFE	3.5%	5.4%	1.7%	-2.1%	8.6%
MSCI Emerging	1.9%	15.8%	13.6%	0.5%	34.8%

With 4th quarter results not yet reported, 2007 earnings for the S&P 500 are estimated to increase 4.4% over 2006. Very poor earnings from the Financials and Consumer Discretionary sectors will drag the overall index's earnings down, while most other sectors will likely increase earnings 6-10% over last year. At the beginning of 2007 analysts expected Financials to grow earnings 6% for the year. Now they estimate that Financial earnings will drop 19% versus 2006 due to sub-prime related losses, restructurings, and write-downs.

Credit Markets

As a result of the sub-prime mess, there has been a rush to quality, or perhaps a rush to simplicity, in the bond markets. Investors are shunning complex, financially engineered investments and with all the uncertainty about which issuer might take further losses, credit risk is getting much more attention than it has for the past few years. For several years there had not been much extra yield to be had from investing in corporate bonds, even those from low-grade issuers, compared to Treasuries. This year credit yield spreads have widened dramatically and for good reason, but we are still favoring Treasuries, government agencies, and very high-grade corporate and municipal issues over lower-quality issues.

The yield curve is still upward-sloping, with higher yields on longer-maturity bonds than on shorter bonds. While inflation is relatively well-controlled, the rate cuts and repeated liquidity injections by the Fed and other central banks might be setting the stage for higher inflation down the road. This possibility keeps us from venturing much beyond the 10-year range for new bond purchases.

For taxable investors, the bond market's flight to quality has created some unusually attractive opportunities in municipal bonds. With capital having rushed out of everything else and into Treasuries, it is now possible to buy investment-grade municipals that yield as much as Treasuries of similar maturity, but whose income is generally free from federal income tax and typically state income tax as well.