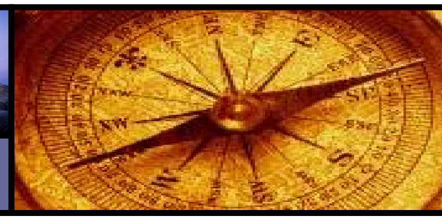
SHARPER ◆ GRANITE



Optimal Portfolio Management

WINTER 2007

IN THIS ISSUE

The stock and credit markets closed out 2007 immersed in fear of a slowing economy. Like Humpty Dumpty sitting pretty on a slippery wall, the economy and the Fed have been trying to balance between threats of recession on one side and inflation on the other. The wobbling associated with that balancing act resulted in unusually high volatility the second half of the year.

Three chief threats, all detailed in our past letters, sit poised to potentially feed on one another and slow the U.S. economy significantly in 2008.

The sub-prime mortgage crisis, discussed in detail last quarter in “High-yield Credit Bubble Bursts”, *Fall 2007*, continues to rattle lenders’ nerves, choking credit supply for everything from business loans to mortgages. This will further exacerbate already accelerating price declines in the residential real estate market (see “The Residential Real Estate Bubble”, *Summer 2005*).[1] Tighter loan standards and housing market downturns each tend to precede economic slowdowns.[2] We currently have a strong dose of both.

Meanwhile, we continue to experience climbing oil prices, mentioned as a leading economic threat in every quarterly Sharper ◆ Granite letter since “Oil, our Most important Commodity”, *Spring 2004*. Three straight years of painfully higher oil prices brought us to $100/barrel on January 2nd, 2008. High oil prices have the ability to lower corporate profits while simultaneously increasing inflation, thus tying the hands of the Fed to lower interest rates and boost the economy.

These three factors could combine to make the U.S. consumer less likely to make major purchases. For every $1,000 a home price declines in a year, its residents spend $90 less as they feel less wealthy. The U.S. consumer has been astoundingly resilient to date, but these challenges are mounting. Consumer spending represents 70% of the U.S. economy, so any crack in the consumer spending rate will slow the economy substantially.

Does all this mean the stock market will soon collapse? Based on these threats, in 4Q07 most Sharper ◆ Granite portfolios were shifted to the “safer” end of their respective target ranges. However, there are reasons to believe that downward pressure on stocks may be not be disastrous. Please read about these positive forces at work in this quarter’s “Fourth Quarter 2007 Economy Review”.

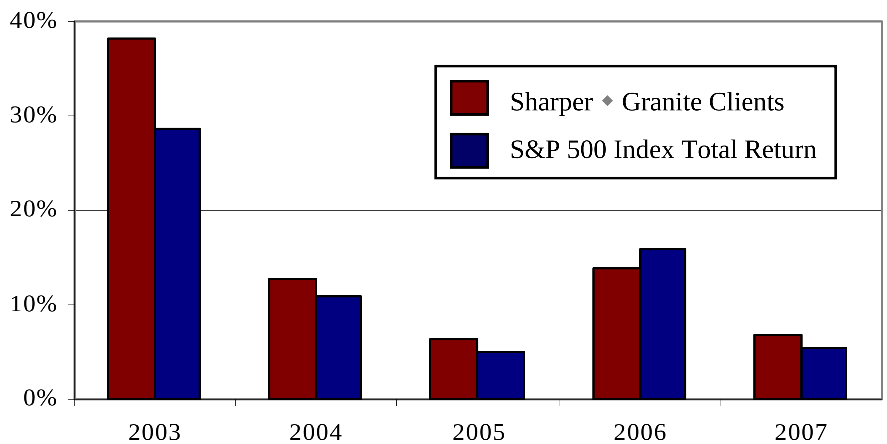
Financial Markets Summary

The pattern of high volatility continued this quarter. Illustrating this recent volatility, investors observed the second consecutive quarter with an official “stock market correction” of 10% in the Dow, followed on November 27th and 28th by the biggest two-day gain in the Dow since 2003. Then as 2008 was getting under way, yet another 10% correction registered for the Dow on January 8.

For 4Q07, the S&P 500 Index returned -3.5% (stock price gain + dividends). This was the first losing fourth quarter in the last 10 years.[3]

Meanwhile, the Leman Aggregate Bond Index, which Sharper ◆ Granite uses as the benchmark for its taxable bond investment performance, returned 3.0% (bond price gain + interest payments) to bondholders this quarter. However, the bond market was actually quite split this quarter as the sub-prime credit crisis continued to simmer, scaring investors out of all bonds with any level of credit risk at all and into treasuries. Demand for safety drove treasury prices higher, and two more Fed interest rate cuts drove short-term treasuries especially through the roof. Meanwhile, even A and A+ rated bonds fell based on concerns that banks will continue to be leery in lending to each other.

Sharper ◆ Granite Returns Vs. S&P 500 Index [4]



The average of all Sharper ◆ Granite client portfolios returned -1.8% (net of fees) this quarter and maintained a risk level 26% less than the S&P 500 Index. If normalized to the same level of risk as the S&P 500 Index, we estimate Sharper ◆ Granite client portfolios would have returned -2.8% (net of fees).[4] Thus, the average of all Sharper ◆ Granite client portfolios beat the S&P 500 Index on both an absolute and a risk-adjusted basis this quarter.

For the year, the S&P 500 Index total return including dividends was 5.5%. The Leman Aggregate Bond Index gained 7.0% with dividends, but again, this index reflects the strength of treasuries, the safest of bonds. Non-treasury bonds of all sorts were generally hit hard the second half of the year.

For 2007, the average of all Sharper ◆ Granite client portfolios, when normalized to the same level of risk as the S&P 500 Index, would have finished an estimated 6.8% (net of fees).[4] Thus, the average of all Sharper ◆ Granite client portfolios beat the S&P 500 Index total return on a risk-adjusted basis this year.

State of the Art Portfolio Projections Available to Sharper ◆ Granite Clients

In the fourth quarter of 2007 Sharper ◆ Granite completed development of a high-fidelity portfolio projection process which features state of the art Monte Carlo statistics software. This software, combined with a powerful Sharper ◆ Granite database provides improved visibility into key questions such as: What will be the value of our nest egg in future years? What is the probability that we will not run out of money by a given age? How much per month do I need to invest in my child's college account to provide a 90% chance that he will be fully funded for a particular college?

This software runs tens of thousands of simulations for a client portfolio varying key unknowns like stock, bond and real estate returns as well as inflation and interest rates to show an array of possible outcomes several years from now. The software uses a powerful, updated Sharper ◆ Granite database to factor not only the probability distributions of these key investment variables, but also how their correlation to one another.

Projection models are maintained for all Sharper ◆ Granite clients, so contact your portfolio manager to see how your model may help answer key financial decisions in your life.

Fourth Quarter 2007 Economy Review

The triple threat of tighter credit markets, declining home prices, and higher oil prices poses a significant headwind to the 2008 economy. While our index of leading indicators is signaling an economic slowdown, a few factors are in place that could limit stock market downside potential.

Since September 18th we have been in an environment of decreasing interest rates, and the Fed will continue to decrease short-term rates in 2008. Interest rate direction is the most significant short-term influence on stock prices. Market returns from 1955 - 2006 averaged only 7.2% in the 12 months following rate increases compared to 18.5% following rate decreases.[5]

Second, stock valuations are fair to low. That is, current stock prices are not at high levels relative to their current and anticipated future earnings. 2007 price/earnings of the S&P 500 companies is 15, near its long-term average.[6]

Finally, the global economy remains strong. While we expect the slowing U.S. economy to drag on world markets eventually, current economic strength overseas along with a weak dollar will continue to provide support to U.S. companies, especially those with overseas growth plans. In fact, large growth company stocks returned 11.2% for 2007 while small-cap stocks, which have few overseas sales, returned -1.5% for 2007.[7]

Leading Economic Indicator Summary

⬆ **Market Cycle:** Looking forward, the first quarter of each year tends to be strong, powered by January which has been the third strongest of the months for the S&P 500 since World War II. [5]

January is a good month but primarily for small caps and international stocks. Small caps have averaged 4.8% return in the month of January since 1925. In foreign countries January returns account for 30% of the total annual return on average.[5]

- ⬆ Strong
- ⬆ Mildly Strong
- ➡ Neutral
- ⬇ Mildly Weak
- ⬇ Weak

Furthermore, as stated above, the stock market rarely performs poorly during times of decreasing interest rates. The only point working against the market cycle currently is that as 2007 closes we have now completed five positive years in a row, and six winning years in a row is extremely rare.

- **Political Cycle:** We are moving into the fourth year of President George W. Bush's term. Traditionally, the third year in the presidential cycle is the strongest, but the fourth year is second best. Since World War II, the fourth year of the presidential cycle has seen the S&P 500 post an average gain of 8.6%. Eleven of the 14 post-WW II fourth years have been positive. On average, the second and fourth quarters of a president's fourth year have been best, averaging 3.2% and 3.1% respectively.[5]

- **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. It is a measure of all goods and services produced in the United States. 3Q07 GDP was revised upward to a sizzling 4.9% annual rate.[30] This represents the 24th consecutive quarter (six full years) of expansion, or positive economic growth, since the official recession of 2001. GDP is expected to be 1.6% in the fourth quarter of 2007.[8]

- **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, is hovering in the region of slow growth. The December ISM report shows the overall economy growing for the 74th consecutive month, but it also shows a manufacturing sector just beginning contraction .[9]

  The Fed's Industrial Production Index also fell this quarter,[10] and both the Philadelphia[11] and New York-area[12] Fed factory indexes plunged in December. Chicago's National Association of Purchasing Management index of business activity rose sharply, showing strong expansion.[13]

- **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The core CPI, which excludes volatile food and energy prices, advanced at a rate in the upward range of that targeted by the Fed. As of October the twelve-month core CPI rate is 2.1%.[14] The Fed's preferred measure of consumer prices, the Core Personal Consumption Index, rose at an annualized rate of 2.2% in November.[15]

- **Oil Price Control:** Oil prices touched $100/barrel for the first time on the first trading day of 2007. Oil prices rose 47.5%[7] in 2007 and continued higher in the opening days of 2008.

  This continues a disturbing trend. Oil is a key input to so many business and consumer products. Its price movement can greatly affect consumers' abilities to travel and purchase leisure-time products. It also impacts the profitability of corporations that produce plastic containers, fly airplanes, drive trains, build trucks, or manage hotels. Oil prices, while volatile, have such a strong influence on the overall economy that they must be watched closely.

  Oil prices rise and fall in long cycles of investment and payback as refinery capacity cannot be added and shuttered quickly enough to respond to changes in world demand. The world is paying the price now for underinvestment in oil production and refining throughout the 1980's and 1990's.[16]

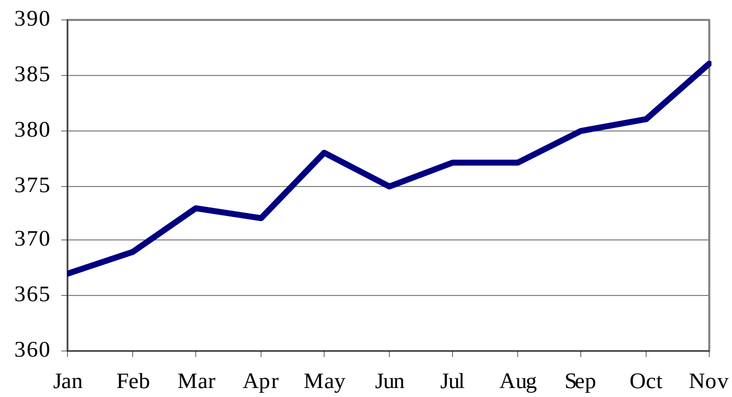
- **Consumer Spending:** Despite concerns from every angle that the housing market decline and sub-prime credit crisis would finally sink U.S. consumer spending, the important holiday shopping season came in strong. In November Americans spent at their fastest pace since July, 2005.[15] Early indications from retailers in December were also strong, led by a 19% increase in online sales over last year.[17] The expected final 4Q07 inflation-adjusted consumer spending growth rate is a healthy 2% or more over 4Q06.[18]

A growing percentage of gift cards now account for holiday shopping. Revenue from gift cards is not recorded until the cards are redeemed, delaying revenue recognition in accounting books until 1Q08 and beyond, which will help retail numbers in coming months.

In every quarter except one since 1981, consumer spending rose over the previous year, adjusted for inflation.[19]

Along with strong holiday retail sales came improved consumer sentiment. According to the Conference Board the Consumer Confidence Index bounced in December, but off of November readings that were the lowest in 4 ½ years.[20]

U.S. Retail Sales ($ billions) [18]



➡ **Business Capital Spending:** Corporate profitability and balance sheets continue to show strength,[21] which is key to helping the business community weather the current credit crunch. That is, in this time of difficulty finding loans, many businesses will be able to draw on their large cash reserves.

As for future expectations, 180 large company CEO's surveyed by *Chief Executive* magazine show business confidence to be at a four-year low. This survey has a good record of foreshadowing jobs data six months in advance of the Bureau of Labor Statistics' official data.[22] CFO's monitored by Duke's Fuqua School of Business and *CFO* Magazine also predict slowing employment.[23]

⬆ **Investor Sentiment:** Current investor sentiment has turned slightly bearish. The bull/bear ratio in the Investors Intelligence Survey declined to 1.8. from a 2007 high point of 3.1 in October,[24] and the UBS Index of Investor Optimism plunged 37% to its lowest level since hurricane Katrina.[25] The bearish sentiment in these measures is considered a positive leading indicator for the stock market as it indicates that worried investors may have already sold their stock positions, providing future potential cash to flow into the market, especially with low interest rates making bonds an unattractive competitive investment.

⬆ **Corporate Earnings:** 3Q07 earnings fell only 1%, and most of this damage was linked to housing and the credit-market turmoil.[6]

3Q07 earnings relative to their stock valuations are still excellent. The price/earnings of the S&P 500 companies is 15 (based on 2007 earnings), in line with its long-term average.[6] Stocks do not appear to be overvalued relative to historical norms.

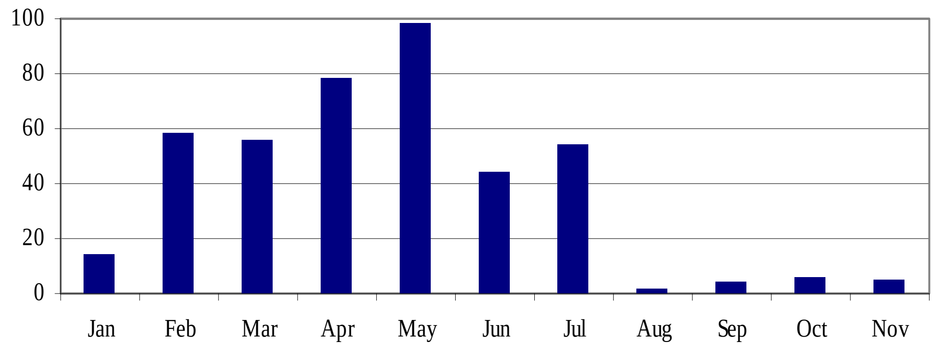
➡ **Insider Trading:** Significant insider buying implies that managers have positive information about their company's outlook. Insider buying increased to a 30-day moving average of over $40 million/day, one of its highest readings in the last two years.[26] However, early January readings are cooling off.[26] Perhaps surprisingly, REIT executives and directors have been buying their companies' stocks. In the second quarter of 2007, they bought more than in the past 6 ½ years.[27]

⬇ **Merger and Acquisition Activity:** As expected, the private equity that was driving much of the M&A activity has dried up significantly due to the tightened credit environment. Tighter credit means higher costs of borrowing for leveraged buy-outs.

The private equity bubble is in fact bursting. Early in 2007 the average buyout price was 15 times cash flow, nearly a fourfold increase from 2002 and matching the frothy level reached just before the LBO market blew up in the late 1980's.

Furthermore, firms have begun flipping their recently bought-out companies to each other rather than selling to corporate buyers. Sanity may return the hard way for some of these firms.[28]

U.S. Private Equity New Investments ($ billions) [29]



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4. Global Investment Performance Standards (GIPS) Original Dietz Method used to calculate returns. Arithmetic average used for return measurement. Performance is net of fees and may include assets tracked for clients that lie outside Sharper ◆ Granite direct management. Such assets total less than 4% of total assets. All client portfolios weighted equally in calculation of average client performance. S&P 500 Index returns include dividends. Past performance does not guarantee future results. Normalization to similar risk as S&P 500 uses weighted average beta of all client portfolio assets, then normalizes to beta = 1.0 (S&P 500 Index beta) using the Securities Market Line (SML). The SML is constructed as a line on the beta-return chart between two points, A and B: A. The point representing "risk free" at beta = 0, return = 3 month return of the 90-day Treasury Bill rate on the last day of the quarter. B. The point representing the "market return" at beta = 1, return = 3 month total return (including dividends) of the S&P 500 Index
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Questions?
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