MCG Journal

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In this edition of the MCG Journal, a market overview of the second quarter of 2007 will be discussed. Also, there will be a recap of the heavily covered story of the losses suffered at Bear Stearns from the sub-prime mortgage debacle. Lastly, the exciting topics to be presented at MCG's 2008 Client Conference, "Exploring Contemporary Investment Strategies", will be listed.

SECOND QUARTER 2007 MARKET OVERVIEW

Despite rising bond yields, an increasingly tough housing market, and rising oil prices, stocks prevailed in the second quarter of 2007. While consumer spending was weak from high gas prices and the challenging housing market, the solid flow of private equity transactions coupled with stronger government and business spending drove economic growth to its highest level in more than a year. Even with this relatively strong growth, inflation appeared to stabilize and the Fed left the fed funds rate unchanged at 5.25%.

Although investment in home-building dropped in the second quarter by 9.3% annualized, government spending increased 4.2%, and businesses increased their spending, as defined by fixed investments in structures, by an astounding 22.1%. Investment in new plants, buildings and other commercial construction was the highest in 13 years. Investments in equipment and software posted a 2.3% increase.

GDP (gross domestic product) growth, the key indicator of the country's economic health, was 3.4% annualized for the second quarter, a major improvement from the prior quarter's sluggish 0.6% increase. The economy outpaced the consensus estimate of analysts' expectations, which was 3.2%.

While GDP growth was markedly improved, the core inflation rate, excluding food and energy, rose just 1.4%. This was down sharply from a 2.4% jump in the first quarter of 2007 and was the smallest increase in four years.

The S&P Index returned 6.3% for the second quarter, while the Russell 2000 and Russell Midcap Indices returned 4.4% and 5.3%, respectively. Overall, growth outperformed value across all capitalization sizes, but shone in small cap space, outperforming value by as much as 400 basis points. International markets—except for Japan—fared quite well. The MSCI EAFE Index gained 6.4% for the quarter.

Consistent with the high oil prices and increased commercial spending, Energy, Technology, and Industrials led the S&P 500 with the strongest quarterly performance. However, the rising long-term interest rates and concerns in the housing market hit Utility and Financial sectors. In spite of this, the unemployment rate has remained low at 4.5%, which could dampen the negative effects. ***See Figure 1.***

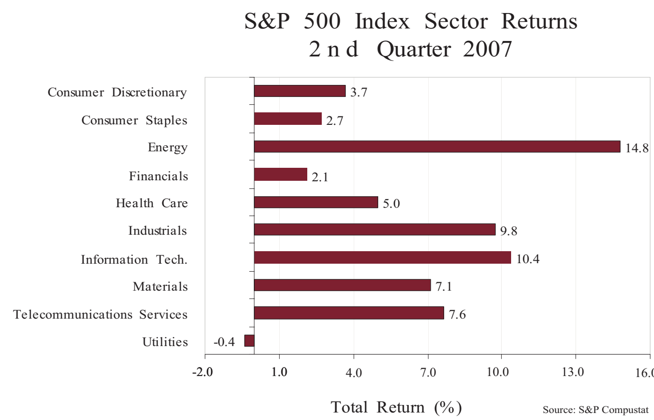

FIGURE 1

The P/E (price-to-earnings) ratio, a measure of the market valuation of a stock, was, on average, 18x at the end of the second quarter. This was up slightly from the prior quarter's measure of 17x, and is only just above the long-term stock market average of 16x. Although the overall stock market was not as cheap in the second quarter as the in first of 2007, the pace of buyouts remained strong, driven in part by the continued availability of cheap credit.

It remains to be seen, however, whether the buyout drive will continue. With short term rates unchanged, the yield curve shifted up 35 basis points on average. The yield on the 10-year Treasury note increased 38 basis points from 4.64% at the end of March to 5.02 % by the end of June. ***See Figure 2.***

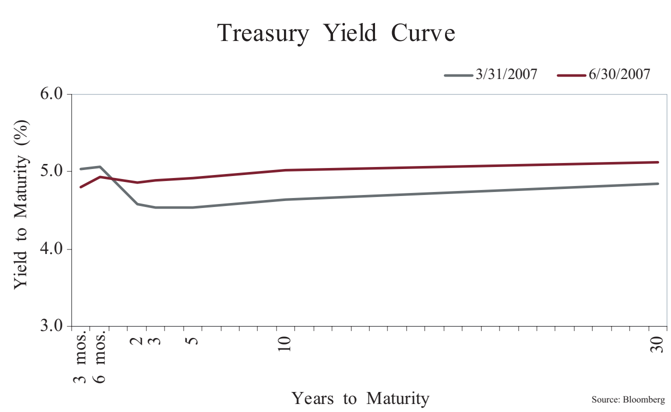

FIGURE 2

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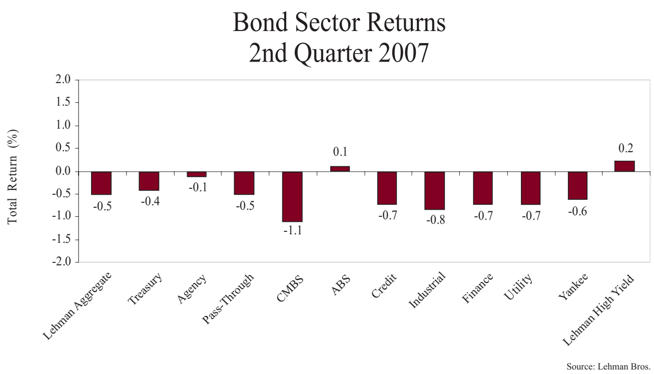

FIGURE 3

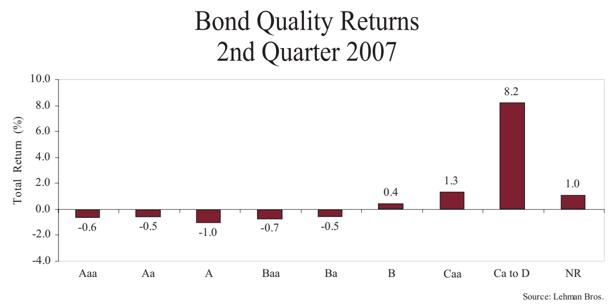

FIGURE 4

In addition, as shown below in Figures 3 and 4, investors are demanding higher premiums for high yield debt as well as asset-backed securities (as interest rates go up, bond prices go down, resulting in negative returns). This could prove significant for the S&P 500, given how much of its return has been driven by takeovers. Currently, 19 companies–representing 1.7% of the capitalization of the Index–are being acquired. ***See Figure 3 and 4.***

THE BEAR STEARNS SUB-PRIME MORTGAGE DEBACLE

While problems in the sub-prime sector of the housing market have been ongoing, the highly publicized liquidation of the Bear Stearns' funds has brought increased attention to this space. Sub-prime mortgage loans are made to the least credit-worthy buyers and currently represent some 15% of the mortgage market. As the housing market has slowed and home prices have stalled or dropped, home loan balances have started to exceed the market values of homes, creating negative home equity and an increase in the expected default rate.

The Bear Stearns High Grade Structured Credit Strategies Fund and the Bear Stearns High Grade Structured Credit Strategies Enhanced Leverage Fund suffered substantial losses due to their investments in collateralized debt obligations (CDOs) backed by sub-prime residential mortgages. The Funds employed a high degree of leverage and held large net long positions, which led to the significant losses in the Funds as the sub-prime mortgage market declined. Based on conversations with several investment managers, there do not appear to be many other hedge funds similar in the structure of the Bear Stearns Funds. Nonetheless, the resulting market impact on the broader markets could include disruptions in the sub-prime residential mortgage sector, increasing volatility in the broader credit and equity markets, and more difficulty and higher costs related to financing transactions.

2008 CLIENT CONFERENCE

The topic for this year's conference is "Exploring Contemporary Investment Strategies." A special series of educational sessions will provide an in-depth analysis of the intricacies of global, hedged, and private equity investment strategies. The goal is to remove some of the mystery that surrounds these complex asset categories by digging deeper into these strategies and providing real life examples of the underlying investments. There will also be a session on the "Human Emotion of Investing" examining where some of the common human factors that influence the typical investors' decision making process.

Save the Date

2008 Client Conference
Sheraton Maui
Maui, Hawaii
Friday, February 1 to Tuesday, February 5, 2008

IFEBP Breakfast
Ralph Brennan's Jazz Kitchen
Downtown Disney – Anaheim, CA
8–11a.m. Sunday, November 4, 2007