2ND QUARTER 2007

WaterStreet QUARTERLY

CAPITAL MARKETS REVIEW AND OUTLOOK

Global Equities Continue to Dominate

Record M&A activity in both Europe and the US, share buybacks, and steady earnings growth again propelled performance.

GLOBAL EQUITY MARKETS continued to generate outsized returns during the second quarter of 2007, as the MSCI All Country World Index rose 6.7%, and the All Country World ex-US Index advanced 7.2%. Performance was again driven by record merger and acquisition (M&A) activity in both Europe and the US, share buybacks, and steady earnings growth. Bonds produced negative returns globally as many central banks continued to tighten to combat potential inflation.

Emerging market equity was the best performing asset class for the quarter, returning 15.1% in the second quarter and 17.8% year-to-date. Returns were driven by continued strong GDP growth and subsequent earnings expansion. Brazil, Chile, China, Hungary, and India all returned over 20% for the quarter. The worst performing asset class was real estate, falling -6.5% as measured by the Morgan Stanley All Country World Real Estate Index (MSCI ACWRE). Rising interest rates and a dra-

QUARTERLY OVERVIEW

US Equities

US stocks produced positive returns for the fourth consecutive quarter fueled by solid earnings growth and a resurgence in private equity and merger activity. The S&P 500 returned 6.3% for the quarter and finally set a new record high. The previous record of 1,527 was set March 24, 2000. All capitalization segments performed well with growth slightly outperforming value. Returns were propelled by the energy and information technology sectors which produced robust returns of 14.8% and 10.4%, respectively. (page 2)

International (Non-US) Equities

International developed and emerging equity markets continued to outperform the US markets fueled primarily by higher GDP growth. The Morgan Stanley EAFE and Emerging Markets Indices returned 6.7% and 15.1%, respectively. (page 3)

Fixed Income

International and US fixed income markets posted negative returns for the quarter with the Lehman Brothers Aggregate Index and the Citigroup Non-US World Government Index returning -0.5% and -1.8%, respectively. The US Federal Reserve left the federal funds rate at 5.25% while the European Central Bank hiked rates by 0.25% in June. (page 4)

Alternative Investments

Hedge funds and hedge fund of funds produced the best returns of the general alternative classes with the HFRI Hedge Fund of Funds Diversified Index returning 4.5% for the quarter. The Dow AIG Commodity Index fell -0.1% as natural gas prices fell substantially. Real estate, as measured by the NAREIT Index, declined -9.0% as interest rates increased and sub-prime mortgage defaults continued to accelerate in the US. (page 5)

Global Outlook

World GDP growth continues in the 4.5%-4.9% range, significantly higher than its long-term trend of 3.7%. Inflation concerns were muted somewhat by the continued housing slump in the US and by a moderation of core inflation in most developed countries. (page 7)

WaterStreet
Investment Consultants, LLC
100 Congress Avenue • Suite 1400
Austin, TX 78701
512.334.3300 • phone
866.747.3300 • toll-free
512.334.3301 • fax
www.waterstreetconsultants.com

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matic increase in mortgage defaults in the US were the catalyst for the sell-off in publicly traded real estate investment trusts and operating companies.

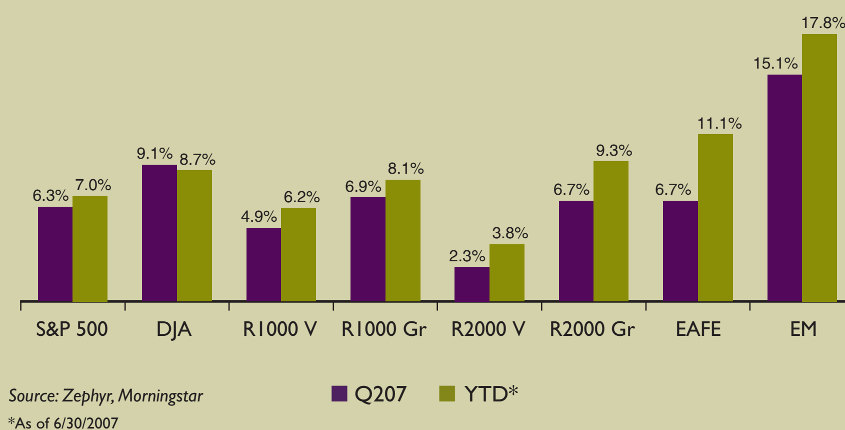
The most significant news in the US was the continued dislocation of the sub-prime mortgage and structured credit market. Both markets experienced a dramatic sell-off as two Bear Stearns hedge funds recorded dramatic losses on leveraged and illiquid sub-prime mortgage exposures in their collateralized debt obligation investments (CDOs). The concern is that the sub-prime mortgage woes will spill over into the Alt A mortgage market and other structured credit markets will also deteriorate. This is very concerning as this mortgage and CDO contagion has begun to roll into the credits markets. This could be exacerbated if tightening by central banks continues.

The European Central Bank, Bank of Japan, and the Bank of England all increased short rates in the quarter as above trend GDP growth and core inflation exceeded targets. The US Federal Reserve left the federal funds rate at 5.25% at its most recent Federal Open Market Committee (FOMC) meeting. The federal funds rate has remained constant since June 29, 2006. The Fed remains concerned over the tight labor markets and above trend wage growth and the inflationary impact they have on the economy. For now, the Fed seems content to manage monetary policy on a "data dependent" basis. Easing of rates seems very unlikely unless the excess liquidity in the system dries up because of some event in the capital markets. The US Federal Reserve continues to be concerned with higher than desired core inflation as well as the recent spike in energy prices.

The global economy continued to grow above its long term trend of 3.7%. 2007 growth continues at a 4.5%-4.9% rate even though growth in the US has slowed to less than 2.0%. Major risk factors continue to be liquidity concerns in the event of major pricing dislocation in the credit markets, US current account deficits, and wage inflation.

EXHIBIT 1

MAJOR US STOCK MARKET INDICES

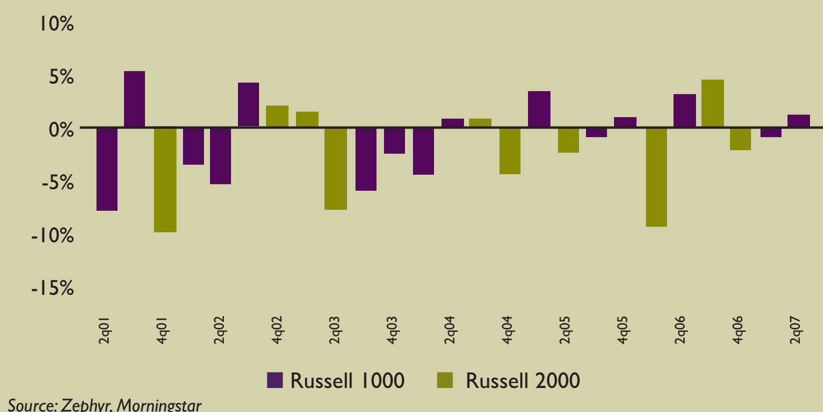


Source: Zephyr, Morningstar

*As of 6/30/2007

EXHIBIT 2

LARGE CAP vs. SMALL CAP



Source: Zephyr, Morningstar

US EQUITIES

The US stock market increased sharply in the second quarter despite poor performance in June. US GDP gained at a 3.4% annual rate during the second quarter. This is the fastest rate since the first quarter of 2006. There was also positive growth in the labor market. Investors responded positively to a decline in core inflation during the quarter. Volatility increased during the quarter, mainly in June, as significant losses to two structured credit hedge funds led to anxiety over credit quality in the leveraged and sub-prime loan markets.

The S&P 500 Index ended the quarter with a 6.3% gain, pulling the year-to-date return to almost 7.0%. The Dow Jones Industrial Average was up 9.1% while the NASDAQ returned 7.7% for the quarter.

Favorable corporate earnings and a booming global economy helped to spur the US market during the quarter. The most significant contributor to capital markets continued to be

record high merger and acquisition activity. M&A activity during the quarter hit a new record high in a three month period of $1.65 trillion. This appears to have been fueled by large reserves of under-invested assets, low interest rates, and tight credit spreads. Please refer to Exhibit 1 to see returns on all major indices.

Economic sector returns were led by energy and information technology, which returned 14.3% and 10.2%, respectively. Oil prices spiked during the second quarter and global demand remained robust, which secured a solid return in the energy sector. Information technology improved as business spending increased during the quarter. Financials and utilities were the two worst performing sectors for the quarter posting 1.5% and -1.1% returns, respectively. The financials sector is still suffering due to the continued concerns over mortgage lending. Utilities suffered in tandem with the rise in interest rates.

Growth oriented stocks are generally affected more than value stocks during periods of M&A activity; it stands to reason that growth outperformed value during the quarter. The Russell 1000 Growth Index posted a 6.9% return for the quarter compared to 4.9% for the Russell 1000 Value Index. This trend continued in the small capitalization market with the Russell 2000 Growth Index gaining 6.7% and the Russell 2000 Value Index returning 2.3% for the quarter. Large capitalizations slightly outperformed their small capitalization counterparts for the quarter with the Russell 1000 Index returning 5.9% versus the Russell 2000 Index's return of 4.4%. This is typical of an increase in times of risk aversion as investors seek the lessened volatility that typically accompanies large capitalization companies. Please refer to Exhibit 2.

Mutual fund outflows from large capitalization stocks continued as $22 billion was withdrawn and redeployed primarily into the M&A heavy mid capitalization sectors and international equities. According to Lipper Analytical over $87 billion flowed into international and global equity funds during the first half of the year.

INTERNATIONAL EQUITIES

Developed Markets

International markets, which have been soaring for more than five years, continued to outperform in the second quarter of 2007. The MSCI EAFE Index gained 6.7%, bringing the year-to-date return to 11.1%. Most developed international markets produced positive results during the quarter with the exception of Japan which returned -0.6%, in US dollar terms (refer to Exhibit 3). Developed European countries rose 8.7%, while Asian-Pacific countries returned 2.3%. Developed Far East countries only managed to return 0.3% during the quarter, in US dollar terms.

The general devaluation of the US dollar continued to enhance returns for US investors. The dollar did appreciate against the Yen during the second quarter. However, the US dollar depreciated against the Euro, declining more than 5% against the Euro in the past 12 months, ending June 30. The US dollar's share of global foreign exchange reserves fell to the lowest level in at least eight years as central banks accelerated purchases of Euros, according to the International Monetary Fund.

Several European countries produced double-digit gains. Germany posted another outstanding quarter, gaining 17% (25% year-to-date) due to strong economic growth and rising tax revenues. Finance Minister Peer Steinbrück indicated that Germany might achieve a balanced budget next year, two years earlier than expected. Portuguese financials, Finnish consumer staples, consumer discretionary, and technology, and Norwegian industrials also added to returns in the second quarter.

Energy and commodities dominated the Canada, Australia, and Norway markets producing double-digit returns. Canadian companies in the materials sector such as nickel, copper, and zinc producers also performed well during the quarter.

Japan continued its stretch of underperformance which was exaggerated in US dollar terms by a depreciating Yen. While the country has been the laggard recently, Japan shows signs of a fundamentally attractive market. With low interest rates, accelerating GDP growth, forecasted 2007 earnings growth of 16%, and low unemployment, Japan shows signs of a fundamentally attractive market and seems poised to perform well.

Cyclical sectors outperformed defensive sectors in the second quarter. Strong performing sectors were industrials, materials, capital goods, energy, and technology. Weak performing sectors were pharmaceuticals, real estate, health care equipment, retailing, consumer staples and discretionary, and health care.

Emerging Markets

Rebounding from the late February sell-off, emerging markets produced strong returns in the second quarter. The MSCI Emerging Markets Index rose 15.1% in the quarter, bringing the year-to-date return to 17.8%. Latin American and Asian countries outperformed Eastern European countries (please refer to Exhibit 4). Most emerging economies are still growing faster than developed economies as China's GDP growth estimate increased to 11% for the year and India's consensus growth estimate will surpass 8% this year. This growth combined with controlled inflation and current account surpluses have helped

many emerging market currencies to strengthen against the US dollar.

Driven by Brazil, Latin America once again produced strong results benefiting from rising energy and commodity prices. Brazilian and Mexican stock markets hit record highs during the quarter amid continued mild inflation. Brazil's central bank cut rates in June. Additionally, Brazilian telecom and financial companies rose along with Mexican material companies.

Asia produced strong results during the second quarter due to continued growth in China and South Korea. China returned 24.5% as industrial profits surged. GDP growth in the second quarter grew at its fastest rate in 11 years, in large part due to the strong Chinese consumer. With rapid growth, low interest rates, and a strengthening currency, the consumer is extremely optimistic. Consequently, in order to ease investors, the Ministry of Finance announced a hike in the stamp duty on domestic stock trades which resulted in another Shanghai market correction. In South Korea, the market was driven high by continued increases in exports, financial stocks, and shipbuilding companies, all contributing to their indices hitting new records in June. The Bank of Korea held interest rates steady during the quarter.

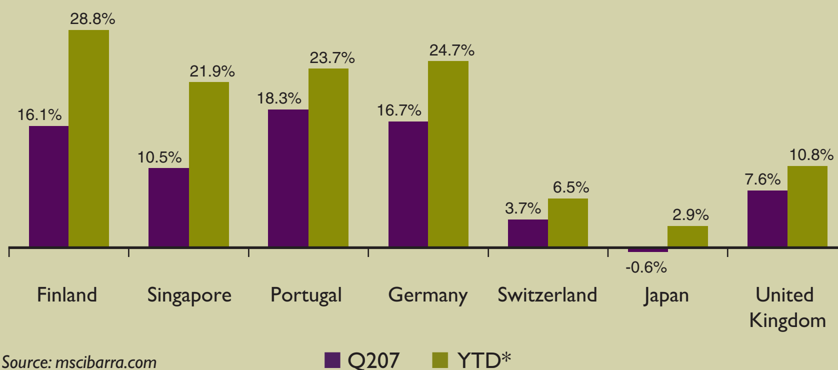
Russia and South Africa hampered relative emerging market performance returning 0.5% and 2.7%, respectively. Russia slowed down in the second quarter as concerns over the president's succession weighed on stocks. Inflation concerns and the possibility of higher interest rates caused South Africa to post a modest second quarter return.

Strong performing sectors were industrials, telecom, and capital goods. Weak performing sectors included consumer discretionary, health care, and technology.

EXHIBIT 3

DEVELOPED MARKETS

(In US Dollars)



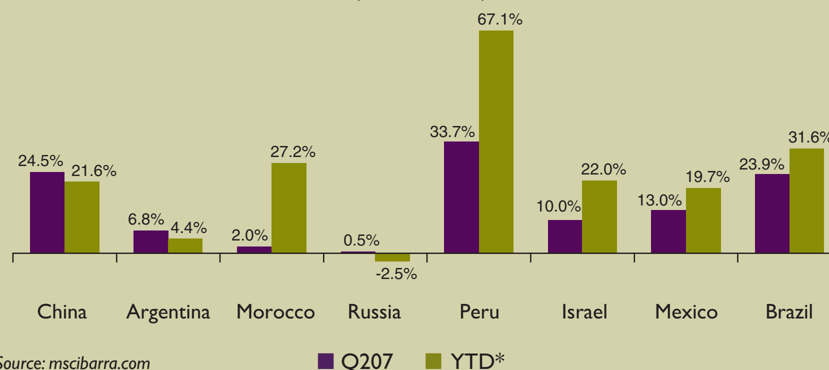
Source: mscibarra.com

*As of 6/30/2007

EXHIBIT 4

EMERGING MARKETS

(In US Dollars)



Source: mscibarra.com

*As of 6/30/2007

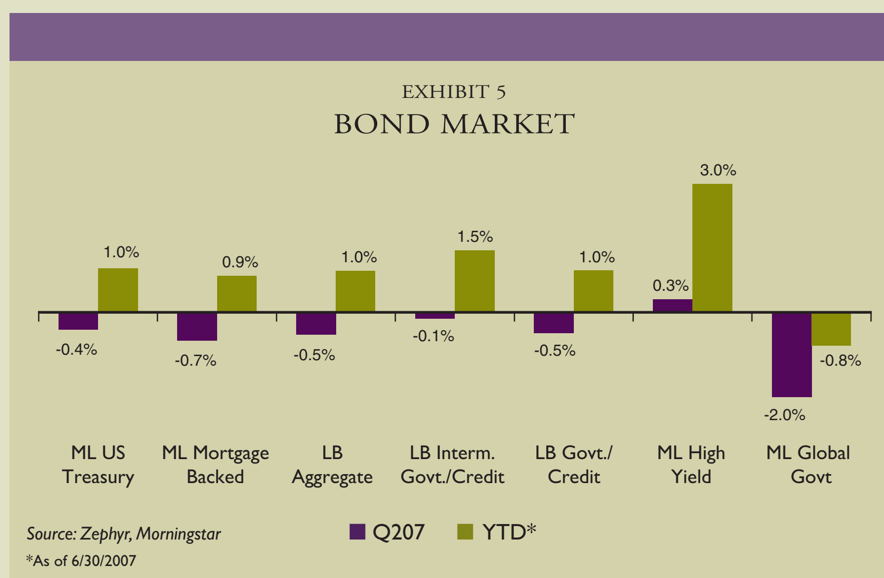
FIXED INCOME

The US Federal Reserve left the federal funds rate unchanged during the second quarter of 2007 due to their continued concern about inflation. Economic data released during the quarter gave little indication of economic weakness. Overall interest rates increased during the quarter due to worldwide growth and capital flows. Rates also increased in Europe and the UK as central banks tightened due to their inflation concerns. This left most bond markets negative for the quarter with the exception of cash and high yield securities. The Lehman Brothers Aggregate Bond Index was down -0.5% for the quarter but is still positive at almost 1.0% on a year-to-date basis. Refer to Exhibit 5 to see index returns for the bond markets.

China's investment in the US private equity firm, Blackstone Group, raised concern over a potential decrease in demand for US Treasuries in the future. This caused a steepening of the yield curve as some institutional investors sold their longer term Treasuries. We expect strong global growth to continue in the next few years while we expect a cyclical slowdown in the US.

The high yield bond space was one of the best fixed income sectors during the quarter with the Merrill Lynch High Yield Master Index posting second quarter and year-to-date returns of 0.3% and 3.0%, respectively. This return came from April and May performance as spreads narrowed. However, June saw the widening of spreads and the month ended with spreads wider than they were at the beginning of the year.

Emerging market fixed income had a difficult quarter with the JP Morgan Emerging Markets Bond Index posting a -1.4% return; however, on a year-to-date basis, the index is still positive at 1.0%. There was an increase in global risk aversion during the quarter as worries increased surrounding the US sub-prime markets and rising Treasury yields. Africa was the best performing region (0.6%) with Eastern Europe, Asia, the Middle East, and Latin America all posting negative returns. Latin America was the worst performing emerging market region for the quarter with a -2.3% return. It was pulled down by Argentina (-17.0%), Venezuela (-10.4%) and Ecuador (-4.1%) due to a variety of economic and political problems. Argentina faced concerns over energy shortages and rising inflation. Venezuela suffered a worsening business climate as ConocoPhillips and Exxon Mobil abandoned operations there. Additionally, President Chavez threatened to withdraw from the IMF during the quarter. There was also lingering uncertainly about Ecuador's potential intent to restructure debt in the future.



ALTERNATIVE INVESTMENTS

Hedge Funds

The hedge fund industry performed well in the second quarter, posting a 4.7% return as represented by the HFRI Weighted Composite Index. Also of note was the strength of hedge fund of funds during the quarter. These generally more diversified investments, as compared to their single manager counterparts, generated a 4.6% return during the second quarter, as represented by the HFRI Hedge Fund of Funds Index. Exhibit 6 depicts the performance of some widely followed industry benchmarks.

Each major hedge fund strategy, as represented by the HFRI strategy specific indices, generated solid performance during the second quarter. Please refer to Exhibit 7.

Despite the gains posted in most alternative markets over the quarter, underlying currents threaten to derail the robust market which started well before the first quarter. The newly revisited fears regarding sub-prime and collateralized debt obligations (CDO) remain palpable. One of the most heavily reported financial stories in June was the implosion of Bear Sterns hedge funds, which caused a sell-off and repricing of risk across credit markets.

The repricing of risk and the subsequent spread widening that occurred in June will most likely make returns harder to come by in many alternative strategies. The spread between the yield on low-risk and high-risk debt widened by 0.5% over the course of June. Gone are the days of easy credit and high liquidity, factors which were instrumental in the private equity buyout frenzy over the last two years. In June alone, mega buy-outs announced for US Foodservice, ServiceMaster International, and Maxeda were pulled as investors' appetites for additional high yield debt investments soured.

Plenty of investor skepticism remains in the market as rating agencies continue their closer look into the multitude of sub-prime CDOs in the market. As the CDO markets sell-off, savvy distressed debt managers should find opportunities to buy quality securities at beaten-down prices.

Uncertainty and skepticism in the markets sent equity volatility well above its trailing 90 and 120 day averages as seen in Exhibit 8. Increased volatility will create opportunities from which many hedge fund managers will benefit. Should volatility remain heightened, we believe that equity market neutral and equity long/short hedge fund strategies will provide solid returns.

Commodities

The Dow AIG Commodity Index rose in April and May, but then gave the

gains back in June to end the second quarter at -0.1%. A sharp decline in natural gas prices in the month of June was the largest detractor for the quarter. Natural gas fell -17.0% in the second quarter as mild weather and high inventories caused the decline. At the end of June, US natural gas inventories were 18% above the 5-year average.

Crude oil was volatile during the second quarter, ending down -1.8% for the quarter. Ample supplies of crude caused prices to decline during the first two months of the quarter. However, worries over refinery glitches that have plagued the industry led to a sharp increase in prices during June. Reports of refinery utilization at 15-year lows, along with healthy demand levels caused an 8.3% rise in June. A more unusual occurrence during the quarter was the wide spread between WTI and Brent crude prices. A fire at a Valero refinery in West Texas and a series of other disruptions caused a glut of crude inventories at Cushing, Oklahoma (the delivery point for WTI crude contracts). The spread got as wide as $6.54 per barrel in mid May. By the end of June, supply had declined and the spread narrowed back to end June at $0.75. Unleaded gas rose 12.5% during the quarter due to the refinery woes and strong demand.

Grains rose 7.7% during the quarter as investors worried over weather conditions delaying next year's crop. Wheat prices set 11-year highs on reports suggesting that global wheat supplies may fall to levels not seen since the early 1970s. Drought conditions in Russia, Ukraine, and Australia have put their crops in danger, while persistent soggy conditions have hampered harvest of the winter wheat crop in the US. Corn prices rose early in the month on expected demand for alternative fuels. However, the USDA's closely watched acreage report showed US corn acreage up 19% from the previous year. The June 29 report caused a sharp decline in corn prices.

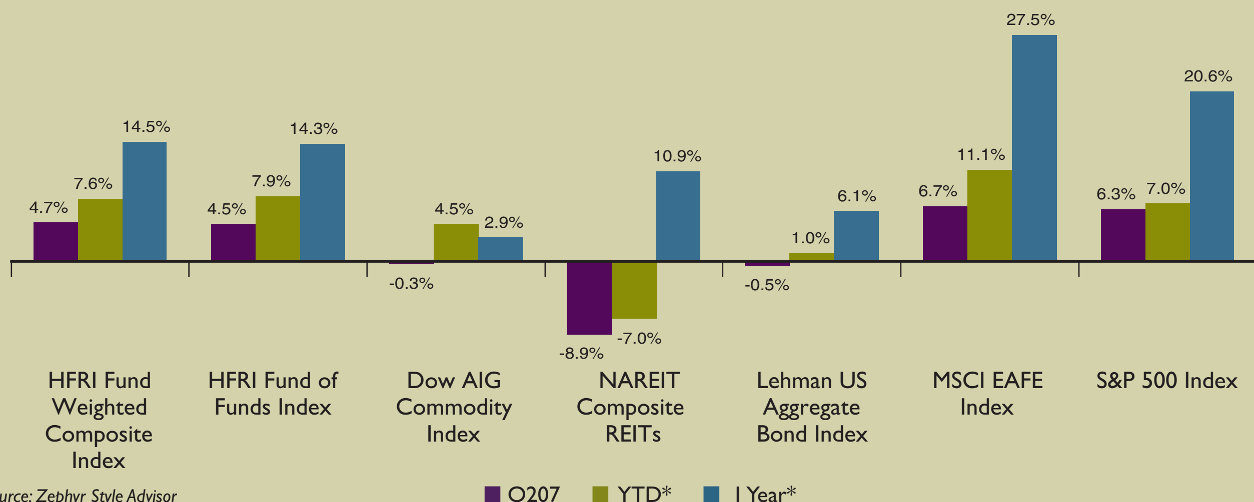
Industrial metals were up 9.0% in April, but declined the following two months to end the quarter at 0.6%. Copper and zinc had particularly large gains in April due to dollar woes, labor problems, and strong Asian demand. In May, metals dropped on concerns that demand from China and the US would decline. In June, the London Metal Exchange (LME) amended its lending rules, lowering the limit at which holders of dominant long positions are required to lend to the market. The rule change, along with general risk aversion about a possible credit market crunch, caused nickel to decline -21.6% in June.

Real Estate Investment Trusts (REITs)

Following seven years of strong total returns, REITs struggled in the second quarter amid mounting speculation over interest rates and uncertainty about asset pricing. The NAREIT Equity REIT Index lost -9.0% in the second quarter. Regional malls and the heath care sectors struggled the most, as these companies are more vulnerable to rising interest rates due to the long-term nature of their leases. The specialty sector, up 2.1%, was the sole positive performing sector in the

EXHIBIT 6

ALTERNATIVE vs. TRADITIONAL INDICES



Source: Zephyr Style Advisor

*As of 6/30/2007

quarter. The sector, composed mostly of timberland companies, is perceived to be relatively defensive.

Following first quarter losses, mortgages rose slightly in April and May. However, mortgages dropped again in June, along with the rest of the REIT market to end the quarter down -6.7%. Pessimism in mortgage REITs will likely continue due to the sub-prime crisis and uncertainty in the housing market.

Real estate in developed international countries also experienced a challenging second quarter. The MSCI All Country World Real Estate Index declined -4.3%. The UK and other European countries were particularly weak as investors considered the likelihood of slowing growth and the Bank of England increased interest rates in an effort to control inflation.

Results in Asia were mixed however, overall emerging markets saw significant increases as the MSCI Emerging Market Real Estate Index rose 21.8% in the second quarter. Hong Kong benefited from strong fundamentals and enthusiasm regarding growth in China. Japan sold off during the quarter, in part due to concerns that the Bank of Japan would continue to raise interest rates. Singapore saw double-digit gains, reflecting the country's upwardly revised GDP growth, strong fundamentals, and positive news for the tourism industry as they confirmed Singapore will host a Formula One Grand Prix event for five years starting in 2008.

GLOBAL OUTLOOK

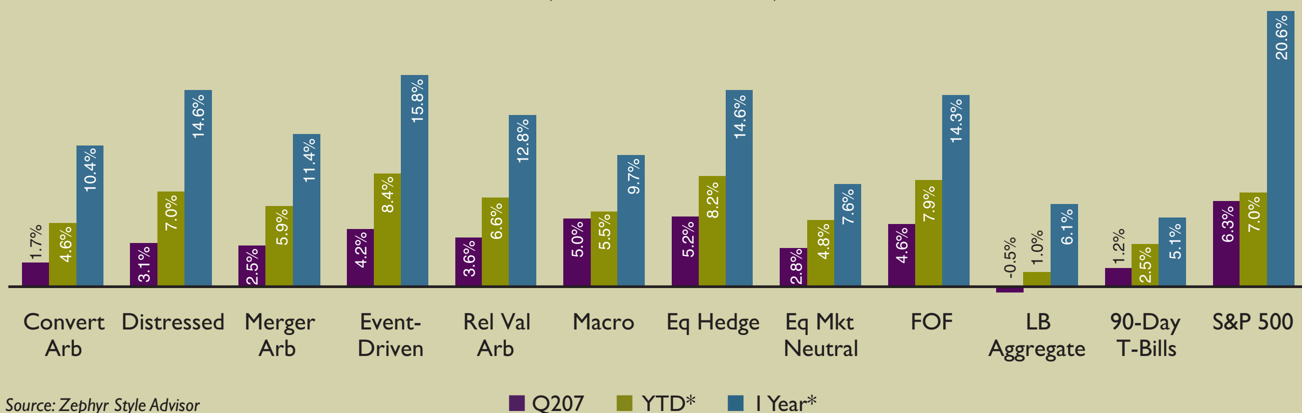
Global growth remains robust albeit slowing from 5.4% in 2006 to a more manageable 4.5%-4.9% range for 2007. This forecasted growth rate remains significantly above the long-term trend line of 3.7%. As the US economy slows considerably, growth in Europe remains relatively unchanged. Growth in Japan, Australia, and Latin America continues to accelerate.

In the US, the economy slowed markedly as growth averaged just 1.7% over the past four quarters. The slowdown reflects the continued effect of the recession in residential housing, higher energy prices, and the continued cost of financing the huge federal budget deficit, forecasted to be $239 billion for FY 2008. The US dollar remains under pressure against the British Pound and Euro depreciating -2.5% and -2.4%, respectively. In our view, the major down move in the Dollar versus the Euro and Pound has probably already occurred over the past five years (60%+). The US dollar should stabilize versus the Euro and the British Pound for two primary reasons. First, US dollar assets are relatively attractive compared to other major developed countries. Second, US fiscal deficits should begin to shrink over the next two years as tax revenue continues to increase in tandem with population growth. Additionally, the US Congress and next administration will likely have no choice but to let the temporary tax cuts passed in 2001 expire with the intention of balancing federal budget deficits. Positive factors include a strong labor market, real wage growth, and continued consumer spending. GDP is expected to grow in the vicinity of 2.0% for 2007.

In Europe, GDP growth continues to surprise. The 2.9% growth rate over the past 12 months has been the best since 2000. Growth has been fueled by strong exports as well as capital investment. However, consumer spending remains flat. Overall growth in the Euro zone remains healthy in the 2.7% range, well over its long-term trend of 1.8%-2.0%. The European Central Bank did raise rates in June by 0.25% to 4.0% and may tighten again in the

EXHIBIT 7

HEDGE FUND STRATEGIES (HFRI INDICES) vs. TRADITIONAL INDICES



Source: Zephyr Style Advisor

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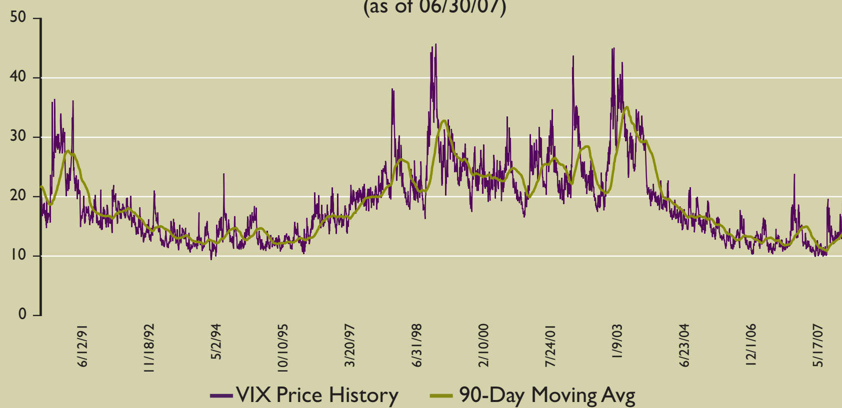

Source: Chicago Board of Options Exchange & Bloomberg

fall if growth remains significantly above trend. In the UK, GDP growth rose to 2.8% in line with its longer term trends. However, further tightening appears likely as inflation hit a 15-year high of 3.1% during 2006.

In Japan, the recovery that began in 2003 continues to gain momentum as business investment activity increases and excess debt is eliminated. GDP growth is projected to be 2.7% in 2007. This growth should facilitate continued improvements in the labor markets and, in turn, consumer spending.

Since the second quarter of 2006, we have reiterated the two major risks in global markets in our view. The risks are the cost of financing the huge US current account and fiscal deficits as well as a possible dislocation in the credit markets.

First, the US current account deficit stood at $803.4 trillion or 5.8% of estimated 2007 GDP as of May 1 and continues to be financed by Japan, China, the UK, and others. As of April, Japan owned $615 billion in US Treasury securities, China held $414 billion, and the UK $134 billion. The three countries hold a combined 53% of all US treasury debt. The risk, of course, is if these countries begin to sell currency reserve dollars for a perceived stronger currency. China did sell a small portion of their dollar denominated reserves in June causing a short sell-off in the US dollar. Fiscal deficits also continue to plague the US with the current 2008 budget deficit forecasted by the US Office of Management & Budget to be $239 billion. Also troubling is the personal saving rate in the US which is estimated to be -1.4%.

Secondly, and potentially more serious, is the risk of a dislocation in the credit markets brought about by excessive leverage, untested derivative instruments, and easy credit. We believe risk is starting to be re-priced in the credit markets with disclosure by Bear Stearns that they infused $3.2 billion into two of their proprietary hedge funds that invested primarily in sub-prime mortgages. This may be the "tip of the iceberg" for the sub-prime as well as Alt A mortgage markets. According to Bank of America Securities, close to $600 billion adjustable rate mortgages are due to reset through the first quarter of 2008 in the US. Though this is interesting, the real story is the dramatic increase in appetite for risk in recent years. For example, the spread on the JP Morgan Emerging Market Bond Index was 918 basis points over US Treasuries at its peak in 2002 and stood at 181 basis points on June 30. The spread on the Merrill Lynch High Yield Index was 1,040 at its peak in 2002 and was just 293 basis points at the end of the quarter. Also concerning is the explosion of the Collateralized Debt Obligation (CDO) market, especially those backed by residential mortgages. Mortgage CDO's divide pools of mortgages into different tranches based on projected cash flows and maturity dates. These different tranches are then securitized and sold to primarily institutional investors looking for higher yields than conventional bond portfolios. Many institutional investors felt safe knowing that the majority of CDO's were packaged with many other mortgages and given an investment grade rating by one of the two rating agencies (Standard & Poor's and Moody's). Unfortunately, it appears that the rating agencies got many of these very complicated structures wrong and are in the process of downgrading numerous CDO's. This, of course, brings us to the real problem: the potential loss of confidence in the rating agencies.

In summary, these risks are not new. The situation is reminiscent of 1998 and the demise of the hedge fund, Long Term Capital Management (LTCM). As you may recall, LTCM was a capital rich multi-billion dollar hedge fund that became insolvent in a mater of weeks because of excess leverage, trading in unfamiliar instruments and markets, and being unable to model liquidity.

Course of Action

We continue to favor stocks over bonds and international equities over US equities. Earnings growth has slowed to single digits as expected in the US and Europe. Equity valuations

are beginning to get stretched but continue to be compelling versus fixed income alternatives. We believe bond yields will continue to provide substandard returns for most investors. Traditional bonds could enjoy a temporary rally in the event of dislocation in the CDO, CLO, and CDS markets or a prolonged slump in the US residential housing market. Prospects for rate cuts remain low for the European Central Bank and the US Federal Reserve as wage growth and overall Core CPI remain above targets.

Equity valuations deteriorated somewhat during the quarter due to slowing earnings growth and the strong increase in global equity prices. In the US, the 12-month trailing price-to-earnings (P/E) ratio for the S&P 500 stood at 18.1 on June 30. Although this represents an overvaluation versus historical averages, it compares favorably with the previous market peak in March of 2000 where the trailing 12-month P/E for the S&P 500 was 30.9. The NASDAQ remains 94% below its March 10, 2000 peak of 5,049. European and Japanese equities continue to be attractive relative to US equities with trailing P/E's of 16 and 19, respectively. The 12-month trailing P/E for emerging markets, as measured by the Morgan Stanley Emerging Market Index, was 13.3; approximately 18% below its historic long-term average of 16.3. We remain overweight to non-US equities; however, we do not expect additional returns based on further dollar devaluation for US investors.

Equity style and capitalization opinions remain largely unchanged from last quarter. We still recommend overweighting growth versus value due to the resurgence of two of the largest growth sectors: information technology and health care. Technology companies should benefit from increased labor costs across all industries as well as a five year underinvestment in technology infrastructure. The health care sector continues to exhibit significant pricing power as many providers continue to enjoy double-digit increases. Global telecom continues to make solid gains as the excess capacity of the late 1990's has worked its way out of the system. We are somewhat ambivalent as to market capitalization at the moment with the exception of the mid-cap sector which has become overvalued, primarily due to the extreme number of buyouts in this part of the market and due to investors chasing returns.

The value of private equity takeover deals in the first half of the year eclipsed $2.7 trillion; however, the party may be coming to an end in the private equity space. It seems as all the "low hanging fruit" may have already been picked by the multitude of private equity firms, especially in the US. Compelling valuations and the promise of increased operating efficiencies may have been the drivers of transactions in years past. However, that seems to have changed recently as marginally accretive mergers and buyouts were being completed due to the abundance of cheap money that is made available to private equity firms by banks and hedge funds. However, it now appears that the bankers (to include interim lenders) are becoming more rational about their lending practices and are finally starting to scrutinize the amount of leverage that is being employed in many of these transactions. The ability of the deal makers to obtain credit default insurance that allows them to securitize the loans and move them off their balance sheets is also diminishing. This was evidenced in late June where two private equity groups, Clayton, Dubilier, & Rice and Kohlberg, Kravis, Roberts had to withdrawal a $3.6 billion bond-and-loan deal involving US Foodservice when lenders balked at the lack of protection. Citigroup, Deutsche Bank, Goldman Sachs, JP Morgan, and Morgan Stanley had put up their own capital to "bridge" the financing of the transaction. Obviously, when these types of transactions fall through, these "bridge" loans become long-term items on their balance sheets.

In the alternative asset classes, we continue to expect that above trend global GDP growth will continue to exert pressure on commodity prices, specifically energy and metals. We expect oil to continue in a trading range averaging in the mid $60's. Private equity seems to be topping out as inventory of potential companies dwindles and financing becomes harder to secure. We do believe there will continue to be extensive private equity opportunities that do not require excessive amounts of leverage. Most of those opportunities will be found outside of Europe and the US. Global real estate, especially the residential sector, does not seem to have found bottom. Commercial real estate seems less vulnerable. We are recommending a slight underweight to this asset class.

We remain optimistic with regard to most hedge fund strategies going forward, especially distressed securities strategies due to the continuing deterioration of the credit markets. Event driven managers could also do well as consolidation continues in many economic sectors globally. Low volatility fund of funds should continue to be a good bond alternative as market volatility increases. We continue to prefer to invest in hedge funds of funds as we view them as safer than single manager strategies. However, we are always concerned that a major market dislocation will cause an exit from common security positions at the same time causing a further downdraft in prices. On a positive note, a short pull back in equity prices could be helpful in order to prolong the current equity bull market that began in 2003.

EXHIBIT 9: **Output, Prices and Jobs**

% change from one year ago

	Gross Domestic Product				Industrial Production	Consumer Prices			Unemployment
	latest	qtr*	2007	2008	latest	latest	year ago	2007	Rate‡, %
United States	+1.9 Q1	+0.6	+2.0	+2.7	+1.6 May	+2.7 May	+4.2	+2.5	4.5 May
Japan	+2.6 Q1	+3.3	+2.3	+2.3	+3.7 May	nil Apr	-0.1	nil	3.8 Apr
China	+11.1 Q1	na	+10.3	+9.7	+18.1 May	+3.4 May	+1.4	+2.8	9.5 2006
Britain	+2.9 Q1	+2.9	+2.7	+2.5	+4.0 Apr	+2.5 May **	+2.2	+2.4	5.5 Apr††
Canada	+2.0 Q1	+3.7	+2.4	+2.7	-0.9 Mar	+2.2 May	+2.8	+2.0	6.1 May
Euro Area	+3.0 Q1	+2.4	+2.6	+2.2	+2.8 Apr	+1.9 May	+2.5	+1.9	7.1 Apr
Austria	+3.5 Q1	+3.6	+2.9	+2.6	+6.8 Mar	+2.1 May	+1.7	+1.6	4.4 May
Belgium	+2.9 Q1	+2.9	+2.5	+2.3	+4.6 Apr	+1.3 May	+2.2	+1.8	10.7 May‡‡
France	+2.1 Q1	+2.4	+2.1	+2.2	+1.7 Apr	+1.1 May	+2.1	+1.4	8.1 May
Germany	+3.6 Q1	+2.1	+2.7	+2.3	+3.7 Apr	+1.9 May	+1.9	+1.9	9.1 June
Greece	+4.6 Q1	na	+3.3§	+3.2§	+0.2 Apr	+2.6 May	+3.1	+2.6§	9.5 Mar
Italy	+2.3 Q1	+1.1	+2.0	+1.7	+0.8 Apr	+1.6 May	+2.2	+1.9	6.1 Q1
Netherlands	+2.5 Q1	+2.3	+2.6	+2.5	+5.8 Apr	+1.8 May	+1.7	+1.7	4.6 May††
Spain	+4.1 Q1	+4.6	+3.6	+2.8	+6.5 Apr	+2.3 May	+4.1	+2.6	8.2 Apr
Czech Republic	+6.1 Q1	+6.1	+5.3	+4.9	+14.0 Apr	+2.4 May	+3.1	+2.6	6.4 May
Denmark	+1.8 Q1	+1.9	+2.2	+2.2	+1.6 Apr	+1.8 May	+2.0	+1.8	3.7 Apr
Hungary	+2.7 Q1	+2.4	+2.6	+3.1	+10.6 Apr	+8.5 May	+2.8	+6.8	7.3 May††
Norway	+2.8 Q1	+2.9	+2.7§	+2.5§	+6.1 Apr	+0.3 May	+2.3	+0.8§	2.7 Apr††
Poland	+7.4 Q1	na	+6.0	+5.3	+8.1 May	+2.3 May	+1.2	+2.2	13.0 May‡‡
Russia	+7.9 Q1	na	+6.7	+6.4	+6.7 May	+7.6 May	+9.5	+8.2	6.9 May‡‡
Sweden	+3.0 Q1	+2.6	+3.7	+3.1	+3.6 Apr	+1.7 May	+1.6	+1.7	3.9 May‡‡
Switzerland	+2.4 Q1	+3.2	+2.2	+2.1	+7.3 Q1	+0.5 May	+1.4	+0.6	2.7 May‡‡
Turkey	+5.2 Q4	na	+4.6	+5.7	+1.4 Apr	+9.2 May	+9.9	+8.3	11.4 Q1‡‡
Australia	+3.8 Q1	+6.6	+3.0	+3.2	+3.7 Q4	+2.4 Q!	+3.0	+2.5	4.2 May
Hong Kong	+5.6 Q1	+2.0	+5.3	+4.9	-1.5 Q1	+1.2 May	+2.1	+2.4	4.3 May††
India	+9.1 Q1	na	+8.1	+7.6	+13.6 Apr	+6.7 Apr	+5.0	+5.7	7.6 2006
Indonesia	+6.0 Q1	na	+6.0	+5.8	+11.9 Mar	+6.0 May	+15.6	+6.5	10.3 2005
Malaysia	+5.3 Q1	na	+5.4	+5.6	+0.4 Apr	+1.4 May	+3.9	+2.3	3.0 Q4
Pakistan	+6.6 2006§§	na	+6.8§	+5.9§	+6.8 Sep	+7.4 May	+7.1	+6.3§	na
Singapore	+6.1 Q1	+7.6	+5.5	+5.7	+18.8 Apr	+1.0 May	+1.1	+1.6	2.9 Q1
South Korea	+4.0 Q1	+3.6	+4.3	+4.6	+6.6 May	+2.3 May	+2.3	+2.2	3.4 May
Taiwan	+4.2 Q1	na	+4.2	+4.6	+6.4 May	nil May	+1.6	+1.3	4.0 May
Thailand	+4.3 Q1	+4.9	+4.0	+4.7	+6.7 Apr	+1.9 May	+6.2	+2.5	1.5 Feb
Argentina	+8.0 Q1	+4.1	+7.5	+5.7	+4.0 May	+8.8 May	+11.5	+9.8	9.7 Q1‡‡
Brazil	+4.3 Q1	+3.2	+3.9	+3.7	+6.0 Apr	+3.2 May	+4.2	+3.6	10.1 Apr‡‡
Chile	+5.8 Q1	na	+5.2	+5.1	+3.0 May	+2.9 May	+3.7	+2.6	6.8 Apr††‡‡
Colombia	+8.1 Q1	nil	+5.4	+4.6	+13.3 Apr	+6.2 May	+4.0	+5.1	11.0 Apr‡‡
Mexico	+2.6 Q1	+0.6	+3.2	+3.8	+1.5 Apr	+3.9 May	+3.0	+3.8	3.2 May‡‡
Venezuela	+8.8 Q1	na	+6.6	+3.9	+6.7 Mar	+19.5 May	+10.4	+17.6	8.0 Q2‡‡
Egypt	+7.4 Q1	na	+6.3	+5.6	+10.5 2006	+10.5 May	+5.3	+9.9	9.0 Q4‡‡
Israel	+5.4 Q1	+6.3	+4.7	+4.3	+9.1 Apr	-1.3 May	+3.5	+0.9	7.7 Q1
Saudi Arabia	+3.4 2006§	na	+3.9§	+5.0§	na	+3.0 May	+2.2	+2.7§	na
South Africa	+5.4 Q1	+4.7	+4.8	+4.9	+3.8 Apr	+6.9 May	+3.9	+5.4	25.5 Sep‡‡

* % change on previous quarter at an annual rate.
† The Economist poll.
‡ National definitions.
§ Not seasonally adjusted.
** Economist Intelligence Unit estimate/forecast.
†† Aug-Oct.
‡‡ Sep-Nov.
§§ Year ending June.

EXHIBIT 10: Trade, Exchange Rates, Budget Balances and Interest Rates

	Trade Balance	Current account balance		Currency units, per $		Budget Balance	Interest Rates, %	
	latest 12 months, $bn	latest 12 months, $bn	% of GDP 2007†	Apr 3rd	year ago	% of GDP 2007‡	3-month latest	10-year gov't bonds, latest
United States	-829.9 Apr	-803.4 Q1	-6.2	-	-	-1.4	5.27	5.07
Japan	+92.0 Apr	+186.9 Apr	+4.3	122	116	-4.4	0.63	1.86
China	+216.7 May	+249.9 (2006)	+8.1	7.62	8.00	-1.3	3.08	4.13
Britain	-158.3 Apr	-80.1 Q4	-3.1	0.50	0.55	-2.8	5.92	5.42
Canada	+46.0 Apr	+18.5 Q1	+1.2	1.07	1.13	0.9	4.42	4.60
Euro Area	+8.6 Apr	+8.1 Apr	+0.1	0.74	0.80	-0.8	4.16	4.54
Austria	+0.3 Apr	+10.3 Q4	+2.4	0.74	0.80	-0.8	4.16	4.61
Belgium	+19.5 Apr	+7.8 Dec	+2.0	0.74	0.80	nil	4.22	4.61
France	-34.8 Apr	-32.3 Apr	-1.3	0.74	0.80	-2.9	4.16	4.59
Germany	+227.3 Apr	+167.7 Apr	+4.8	0.74	0.80	0.3	4.16	4.54
Greece	-46.6 Apr	-33.2 Apr	-8.4‡	0.74	0.80	-2.2	4.16	4.73
Italy	-22.4 Apr	-48.4 Apr	-2.1	0.74	0.80	-2.6	4.16	4.76
Netherlands	+43.7 Apr	+16.8 Q1	+8.2	0.74	0.80	0.6	4.16	4.58
Spain	-118.5 Apr	-113.0 Mar	-8.8	0.74	0.80	1.1	4.16	4.61
Czech Republic	+2.6 Apr	-5.7 Apr	-3.8	21.3	22.7	-4.1	2.97	4.57
Denmark	+5.2 Apr	+4.8 Apr	+2.5	5.54	5.95	4.0	4.40	4.60
Hungary	-2.1 Apr	-6.5 Q4	-4.7	184	224	-6.7	7.66	6.60
Norway	+54.1 May	+57.3 Q1	+14.3‡	5.93	6.31	16.8	4.77	5.18
Poland	-7.1 Apr	-8.8 Apr	-2.6	2.82	3.24	-2.3	4.57	5.64
Russia	+129.8 Apr	+85.8 Q1	+5.7	25.8	27.1	2.4	10.00	6.13
Sweden	+19.5 May	+29.8 Q1	+6.6	6.90	7.38	2.2	3.42	4.44
Switzerland	+10.5 May	+106.1 Q4	+15.7	1.23	1.25	0.3	2.54	3.09
Turkey	-53.0 Apr	-31.3 Apr	-7.0	1.33	1.61	-2.7	19.14	6.65§
Australia	-10.8 Apr	-43.8 Q1	-5.3	1.19	1.37	1.4	6.42	6.19
Hong Kong	-18.9 May	+20.6 Q4	+9.8	7.82	7.77	2.7	4.43	4.55
India	-61.3 Apr	-10.0 Q4	-1.8	41.0	46.4	-3.3	7.12	8.45
Indonesia	+41.5 Apr	+9.6 Q4	+2.2	9133	9341	-1.6	8.38	6.68§
Malaysia	+28.3 Apr	+25.6 Q4	+13.5	3.48	3.68	-3.7	3.62	5.55§
Pakistan	-13.6 May	-6.8 Q1	-5.7‡	60.5	60.2	-3.8	9.56	7.03§
Singapore	+35.4 May	+38.1 Q1	+23.3	1.54	1.60	0.3	2.55	2.81
South Korea	+16.6 May	+5.2 Apr	+0.2	928	958	0.5	5.03	5.41
Taiwan	+13.7 May	+28.1 Q1	+6.7	32.8	32.7	-2.2	2.60	2.50
Thailand	+7.0 Apr	+8.8 Apr	+2.1	34.6	38.5	-1.9	3.75	4.12
Argentina	+11.3 May	+7.8 Q1	+2.5	3.10	3.09	1.2	9.25	na
Brazil	+47.6 May	+15.1 Q1	+0.8	1.95	2.23	-2.4	11.93	6.16§
Chile	+25.5 May	+7.1 Q1	+1.3	530	549	5.5	5.40	5.67§
Colombia	-1.0 Mar	-2.9 Q4	-2.7	1982	2635	-0.9	7.93	6.19§
Mexico	-11.3 May	-5.5 Q1	-1.4	10.9	11.4	-0.2	7.19	7.69
Venezuela	+28.2 Q1	+23.8 Q1	+9.8	2147	2634	-4.7	10.15	6.55§
Egypt	-12.6 Q4	+2.7 Q4	+1.5	5.70	5.76	-5.5	6.78	5.60§
Israel	-7.5 May	+8.1 Q1	+3.6	4.27	4.48	-1.0	3.86	4.91
Saudi Arabia	+148.5 (2006)	+95.4 (2006)	+21.4‡	3.75	3.75	16.6	5.04	na
South Africa	-9.9 Apr	-16.6 Q1	-6.0	7.19	7.23	0.5	9.80	8.46

* Merchandise trade only.
† The Economist poll.
‡ Economist Intelligence Unit forecast.
§ Dollar denominated bonds.

EXHIBITS 11 & 12: **Index Tables** (period ending June 30, 2007)

INTERNATIONAL DEVELOPED MARKET PERFORMANCE

	In Local Currency		In US Dollars	
	Q207	YTD	Q207	YTD
REGIONS				
EAFE	6.18%	9.80%	6.67%	11.09%
EURO	9.37%	12.83%	10.96%	15.56%
EUROPE	6.95%	10.60%	8.68%	12.94%
THE WORLD INDEX	6.15%	8.50%	6.71%	9.48%
PACIFIC	4.52%	8.13%	2.27%	7.04%
WORLD ex USA	6.17%	9.72%	7.24%	11.62%
NATIONAL INDICES				
AUSTRALIA	5.28%	12.56%	10.57%	21.16%
AUSTRIA	3.80%	8.80%	5.31%	11.43%
BELGIUM	3.66%	6.75%	5.17%	9.33%
CANADA	6.09%	8.62%	15.05%	18.83%
DENMARK	4.91%	12.58%	6.58%	15.50%
FINLAND	14.47%	25.76%	16.14%	28.80%
FRANCE	8.92%	10.94%	10.50%	13.63%
GERMANY	15.05%	21.80%	16.73%	24.74%
GREECE	5.03%	9.90%	6.56%	12.55%
HONG KONG	5.82%	6.89%	5.77%	6.34%
IRELAND	2.25%	0.50%	3.74%	2.93%
ITALY	3.67%	3.61%	5.18%	6.12%
JAPAN	3.92%	6.64%	-0.64%	2.89%
NETHERLANDS	7.06%	14.16%	8.62%	16.92%
NEW ZEALAND	4.73%	4.56%	13.16%	14.57%
NORWAY	11.69%	17.39%	15.43%	23.75%
PORTUGAL	16.60%	20.79%	18.30%	23.71%
SINGAPORE	11.32%	21.55%	10.52%	21.94%
SINGAPORE FREE	11.32%	21.55%	10.52%	21.94%
SPAIN	3.04%	6.73%	4.54%	9.31%
SWEDEN	6.64%	13.83%	9.11%	13.59%
SWITZERLAND	4.11%	6.88%	3.71%	6.45%
UNITED KINGDOM	5.18%	8.12%	7.59%	10.84%

Source: Morgan Stanley Capital International

INTERNATIONAL EMERGING MARKET PERFORMANCE

	In Local Currency		In US Dollars	
	Q207	YTD	Q207	YTD
REGIONS				
EM (EMERGING MARKETS)	12.63%	15.26%	15.05%	17.75%
EM ASIA	16.61%	17.36%	18.49%	18.78%
EM EASTERN EUROPE	3.87%	2.44%	4.65%	3.53%
EM EUROPE	4.41%	4.31%	5.79%	6.22%
EM EUROPE & MIDDLE EAST	5.40%	6.70%	6.26%	8.22%
EM LATIN AMERICA	14.82%	19.84%	19.81%	27.09%
NATIONAL INDICES				
ARGENTINA	6.36%	5.15%	6.79%	4.38%
BRAZIL	16.62%	18.67%	23.89%	31.55%
CHILE	17.93%	27.71%	20.63%	29.04%
CHINA	24.51%	22.23%	24.45%	21.59%
COLOMBIA	4.57%	-2.90%	17.65%	11.07%
CZECH REPUBLIC	13.95%	21.86%	12.75%	19.55%
EGYPT	10.10%	13.72%	10.17%	14.09%
HUNGARY	26.04%	19.79%	28.73%	25.53%
INDIA	13.23%	7.47%	20.84%	16.79%
INDONESIA	14.86%	14.13%	16.01%	13.60%
ISRAEL	12.17%	22.90%	10.00%	22.01%
JORDAN	-5.01%	4.18%	-4.95%	4.24%
KOREA	16.18%	21.08%	18.28%	21.88%
MALAYSIA	8.66%	25.97%	8.82%	28.73%
MEXICO	10.76%	19.34%	13.01%	19.72%
MOROCCO	0.77%	24.72%	2.00%	27.20%
PAKISTAN	22.63%	41.38%	23.19%	42.34%
PERU	33.42%	66.64%	33.65%	67.10%
PHILIPPINES	15.99%	24.41%	21.01%	31.83%
POLAND	9.31%	18.93%	13.80%	24.00%
RUSSIA	0.33%	-2.86%	0.53%	-2.49%
SOUTH AFRICA	-0.13%	10.02%	2.71%	10.01%
SRI LANKA	-6.43%	-5.67%	-8.43%	-9.01%
TAIWAN	13.40%	11.47%	14.18%	10.52%
THAILAND	16.50%	16.81%	18.13%	22.30%
TURKEY	8.96%	22.39%	15.76%	32.74%
VENEZUELA	-15.77%	-28.42%	25.46%	11.45%

Source: Morgan Stanley Capital International

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