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THREE INVESTMENT THEMES

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What a wild few months – the housing market continued to implode, toxic subprime mortgages caused pain to financial institutions across the globe, the asset-backed commercial paper market stopped functioning, banks stopped lending to each other at market interest rates, Countrywide Financial, the biggest independent mortgage lender, endured a liquidity crisis that almost put it out of business, there was a run on a bank in England, the takeover boom came to a screeching halt, and the stock market has its first 10% correction since the bull market began in 2003. Because of all this turmoil the Fed cut interest rates causing the S&P 500 to rally and end the quarter higher by 2%!

One theme emerging from all the chaos: **Investors worldwide are becoming more risk adverse favoring large-capitalization, globally-focused, high-quality stocks.** There are many reasons to believe this trend will endure.

First, global growth remains robust despite the slowdown in the U.S. The largest U.S. companies have significant business overseas which should keep earnings moving higher. As seen in the volatile third quarter U.S. companies with significant business presence overseas outperformed.

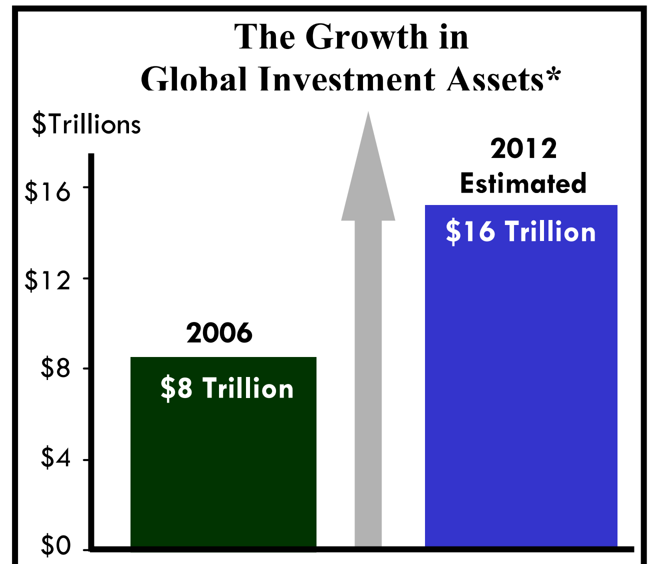
Monetary conditions should benefit large-caps as well. Official inflation measures are trending down. The housing recession and credit crunch are both deflationary events which should keep inflation tame. However, it can be argued that inflation on a personal level is problematic. For many people food, energy, education and healthcare costs are big budget items. These prices are all rising well above the official inflation rate and will likely keep U.S. consumers constrained prompting more rate cutting from the Fed. This action has historically been good for equities. The last two times the Fed went on a rate cutting spree the excess liquidity caused a tech stock bubble (1999) and a housing bubble (2001). What areas are bubble candidates this time around? Our vote would be emerging markets and globally-focused large-cap stocks.

Money flows should also favor large-cap stocks. Over the past decade institutional investors have moved money out of large-cap stocks and into private equity and hedge funds, which in turn tended to buy mid- and small-cap companies. We expect this trend to reverse as large-caps outperform.

More important is the emergence of Sovereign Wealth Funds. These are huge investment funds controlled by overseas governments formed in response to the growth in global investment assets. The most active are from the Middle East and Asia and have an estimated value of $4 trillion. These funds are getting more aggressive in their investments, diversifying out of U.S. Treasuries and other bonds and into stocks. Since these types of investors typically prefer the liquidity of large-cap stocks the additional investment assets coming into our markets could act as a price support or even added buying pressure for our markets.(see the chart showing the growth in global investment assets)

Putting it all together, current conditions should benefit investors who selectively invest in some of the largest well known U.S. companies that do business worldwide. Monetary conditions, investment flows and the emergence of large foreign investment pools favor U.S. Blue Chip companies with a global focus. In addition many of these companies are financially self sufficient with significant liquidity and financial strength giving investors an added margin of safety.

The stock market has rallied impressively from its August lows. However, the economy and financial markets still have a lot of baggage to work through. Investors should expect more volatility and use any pullbacks to increase exposure to Blue Chip companies.



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*Estimated Growth in Assets in Global Capital Markets from Petrodollars, Asian Central Banks, Hedge Funds and Private Equity from 2006 to 2012. Source: McKinsey & Company, October 2007