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May 16, 2008

To: Clients and Friends of the Firm

Subject: Presentation at the 56th Annual University of Chicago
Graduate School of Business Management Conference

Marshall Front will speak at the University of Chicago GSB Conference on Friday, May 16th. Attached is an outline of his prepared comments, which we believe you will find interesting.

* * * *

University of Chicago GSB

56th Annual Management Conference

Talking Points

Marshall B. Front
Chairman

May 16, 2008

TALKING POINTS

MAY 2008 UPDATE -- ECONOMIC OUTLOOK

Recession Talk

1. Weak employment data, the downward spiral in housing, high energy prices, and slowing consumer spending underpin the assessment by a majority of economists we have entered a recession.

   - Since consumer spending accounts for over two-thirds of GDP, it will be hard, analysts argue, to avoid a recession if employment continues to decline and wage increases remain subdued. The economy lost about a quarter million jobs in the first four months of this year. Not since the onset of the Iraq war in 2003 have we experienced job losses for at least four consecutive months.

   - Almost all housing metrics are falling at generationally high rates. The 10+ months' inventory of unsold homes and tightening credit conditions remain a formidable hurdle to a near term turn-around. Meanwhile, housing prices nationally have fallen 12% over the past year and mortgage rates have come down improving affordability.

Recession Talk (continued)

- Consumer spending for goods actually fell in the first quarter, the slowest pace since the fourth quarter of 1991. When spending for services is added, overall consumption rose only 1.0%.

- Consumer confidence, as measured by the Conference Board Confidence index, fell in April to its lowest level since December 1973 when Watergate gripped the nation and the OPEC boycott drove oil prices up.

2. Some *forward looking* and other data, though, cast doubt on the certainty of a recession, defined by the NBER as a significant decline across the economy including inflation-adjusted GDP, income, employment, and retail sales that last more than a few months.

- The Institute for Supply Management (ISM) non-manufacturing index expanded in April to 52 from 49.6 in March, signaling damage from the housing slump and credit crisis may be easing. Readings above 50 portend growth in this sector, which accounts for over 85% of GDP.

- While manufacturing in the US contracted for the third straight month, extending a weakening trend, it has not collapsed. Manufacturing, which accounts for 12% of the economy, appears to have only stalled with the ISM index for April at 48.6 in March, the same as in the prior month.

Recession Talk (continued)

- Factory orders rose 1.4% in March following declines in both January and February possibly indicating businesses are more comfortable now with their inventory needs.

- The ISM's breakeven point for the overall economy is a PMI of 41.1. A PMI of over 41.1 indicates an expanding economy. A PMI reading below 41.1 indicates the overall economy is contracting. The current overall reading remains close to 50.

- Export growth continues to be a source of business strength supported by the weak dollar and strong economic growth abroad.

- The unemployment rate, 5.0%, remains low by historical standards. We have not in two generations experienced a recession with the unemployment rate below 6.25%.

- April retail, ex autos, sales showed a rebound from those of March, rising a surprisingly strong 0.5% with surprisingly good gains in building materials, furniture, and appliances.

- Consumer spending, which accounts for about two-thirds of GDP, is forecast to grow 0.5% this quarter and then rebound to a 2.3% growth rate next quarter as the tax rebates impact the economy. Fourth quarter spending is expected to fall to a 1.6% pace.

Recession Talk (continued)

- First quarter profits for S&P non-financial companies advanced at better than 11% and are forecast to grow 10% in the current quarter -- hardly a recession-like performance.

- Tax rebates, now on their way to 130-million taxpayers, and the lagged effect of Fed interest rate cuts over the past 9 months, will provide a prop to the economy.

- Advance first quarter GDP figures showed a 0.6% rate of growth, identical to that of the 4th quarter of 2007. Following revisions adjusting for inventories and trade, GDP will undoubtedly show a rise of close to 1.0%.

3. Given these factors, we believe whether we are actually in a recession as defined by the NBER remains an open question. What we do know is that to millions of hard hit families, it feels like a recession and that is what really matters, particularly in an election year when politicians are tempted to fix economic problems by enacting legislation which may eventually bring on adverse unintended consequences.

Federal Reserve Policy Shift -- A Pause

- Further reductions in the Fed Funds rate are likely to be of limited value as the recovery will require resolving credit market problems dealing with:

Federal Reserve Policy Shift -- A Pause (continued)

  - homeowners who may now be tempted to default on mortgages that exceed the value of their homes;

  - reducing the risk that the ongoing decline in home prices will force millions of additional homeowners into a negative equity position, tempting them to walk away from their homes and adding to the overhang of vacant residences.

- Fed Funds will remain at 2.0% as the Fed focuses on other means to improve liquidity through additional targeted measures and discount window innovations.

- The Fed's apparent decision to change policy at this juncture is supported by signs of an easing in the credit crisis that gripped the financial markets this winter.

  - stocks have risen 9% from their March lows;

  - yield spreads between US Treasury debt and mortgage-backed securities have narrowed by 75 basis points;

  - spreads between yields on medium grade corporates and US Treasuries have fallen by 60 basis points;

  - LIBOR rates have eased and other measures of liquidity have improved since last winter.

Federal Reserve Policy Shift -- A Pause (continued)

- Systemic risks facing the credit markets in February and March receded when the Fed opened the discount window to large dealers following Bear Stearns collapse in March.

- Short-term rates began to rise in anticipation of this change in Fed policy.

  - two year US Treasury note rates rose from 1.4% on March 17 to 2.5% currently;

  - further increases in yields on short-to-intermediate term US Treasury obligations are likely as credit fears ebb and investors shift their attention to possible Fed Funds rate hikes in 2009;

- The dollar has strengthened vs. the yen and euro.

- Gold, a safe haven to some during a crisis, has seen its price fall 20% since March 14th.

- Fighting inflation with a less accommodative monetary policy is likely to become a higher Fed priority later this year.

Inflation

- Top line inflation near 4.0% is scary, having the potential of altering consumer behavior causing inflation expectations to become unanchored.

- Core CPI inflation, currently 2.3%, has, for several quarters, run well above the upper end of the Fed's comfort zone of 1.0% to 2.0%.

- The recent rises in energy and food prices have been influenced by several factors including:

  - increased demand from China, India, and other developing nations as more people move into the "consumer class";

  - falling interest rates have added to upward pressure on commodity prices by making it inexpensive for commodity investors and speculators to hold larger inventories of oil and food grains;

  - attractive rates have induced some investors to add commodities to their portfolios. When rates are low, portfolio managers bid up the prices of oil and other commodities to levels at which their expected future returns are in line with the lower rates;

  - the interest rate-induced rise in the price of oil also contributes indirectly to higher prices of food gains by making it profitable for farmers to devote more

Inflation (continued)

  - acreage to corn ethanol. The resulting reduction in acreage to producing food crops causes a decline in the supply of those commodities and their prices to rise -- another example of an unintended negative consequence of well-meaning government intervention.

- Rising food and energy prices, excluded from core inflation figures, can contribute significantly to US inflation and the cost of living.

  - the 25% weight of food and energy in the CPI means a 10% rise in their prices and adds 2.5% to the overall level;

  - in lower income, emerging market cultures, food and energy are generally a larger part of consumer spending, adding proportionally more to the cost of living in these nations.

- The higher short-to-intermediate interest rates we anticipate are, therefore, likely to relieve some of the pressure on both energy and food prices as investors’ appetites for commodities wane, the dollar rallies and global economic activity cools.

Forecast

1. Economic growth will be muted until midyear when the impact of the tax rebates and lower interest rates kick-in.

Forecast (continued)

- First quarter GDP will be revised up to about 1.0%. The current quarter is likely to come in at 1.5%.

- Second half growth should average 2.0%+ with higher growth in the 3rd quarter than in the final three months.

- Exports will remain strong and consumer spending will rebound in the current and third quarter.

- Job growth, a *lagging indicator*, will remain weak and unemployment will drift higher toward 5.5% by midyear and 5.75% by year-end.

- Core CPI inflation will remain in the 2.25% to 2.30% range.

- The Fed is done cutting rates unless the economy takes a sharp downturn from its present trajectory.

- The yield curve will steepen with short-to-intermediate term open market interest rates trending higher through year-end. Two year US Treasury rates will rise by about 50 basis points to 2.7%. 10-Year US Treasury yields, currently 3.77% will move to 4.25% to 4.35%.

Investment Strategy -- Take Advantage of Deleveraging

Fixed Income

- *Tax exempt* bond prices came under severe pressure this winter and spring as the credit crunch forced hedge funds and other leveraged institutional investors to liquidate positions. High quality municipals remain attractive to taxable investors as their taxable equivalent yield spreads are near generational highs.

- *US Treasury* obligations have been bought aggressively by investors seeking their safety and marketability. We advise avoiding treasuries preferring high-grade corporate bonds where spreads have widened due to recession fears. Currently, the spread between 10-year AAA rated corporates and 10-year US Treasury bonds is 146 basis points (versus the peak spread this cycle of 183 basis points on March 10th.)

- *Lower grade* bonds also offer attractive prospective returns as spreads remain wide in comparison with where they have been over the past five years. Currently, the spread between a 10-year B rated corporates and 10-year US Treasury is 595 basis points (versus the peak spread this cycle of 667 basis points on April 1st.)

Domestic Equities

- Core domestic large cap *growth and value* shares remain attractively priced:

  - the Fed model shows stocks to be undervalued (see page 14);

Investment Strategy -- Take Advantage of Deleveraging (continued)

- price/earnings multiple for the S&P 500 stock index is about 15x estimated 2009 earnings -- near the median multiple for the past decade;

- large cap *growth* shares have underperformed small cap *value* stocks;

- large cap *growth* stocks in general are undervalued relative to large cap *value* stocks (see page 17).

- Areas of greatest attraction and risk:

Attractive

- *Growth*: *technology* companies where earnings growth is likely to be sustained even if the economy recovers slowly; *consumer discretionary* shares (i.e. retailers);

- *Value*: *financials*, particularly depressed money center banks and GSE's.

Investment Strategy -- Take Advantage of Deleveraging (continued)

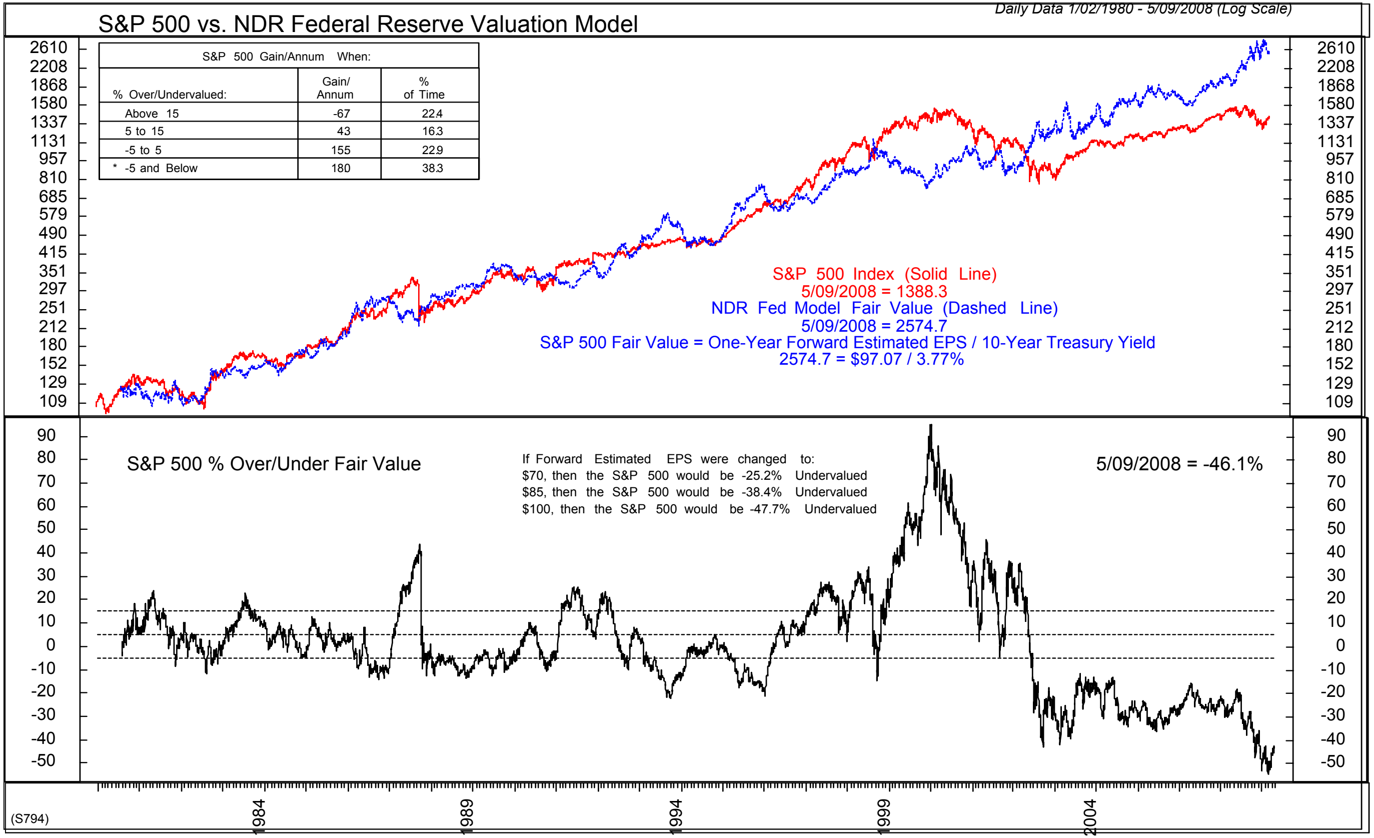
Risky

- Commodities, including gold.
- Energy (see page 15)

MBF
5/14/08

Fed Valuation Model

The Fed stock market valuation model, which incorporates the yield on 10 year US Treasury Notes and estimated S&P 500 profits, shows stocks remain undervalued.



S&P 500 vs. NDR Federal Reserve Valuation Model

Daily Data 1/02/1980 - 5/09/2008 (Log Scale)

S&P 500 Gain/Annum When:		
% Over/Undervalued:	Gain/ Annum	% of Time
Above 15	-67	22.4
5 to 15	43	16.3
-5 to 5	155	22.9
* -5 and Below	180	38.3

S&P 500 Index (Solid Line)
5/09/2008 = 1388.3
NDR Fed Model Fair Value (Dashed Line)
5/09/2008 = 2574.7
S&P 500 Fair Value = One-Year Forward Estimated EPS / 10-Year Treasury Yield
2574.7 = $97.07 / 3.77%

S&P 500 % Over/Under Fair Value

If Forward Estimated EPS were changed to:
$70, then the S&P 500 would be -25.2% Undervalued
$85, then the S&P 500 would be -38.4% Undervalued
$100, then the S&P 500 would be -47.7% Undervalued

5/09/2008 = -46.1%

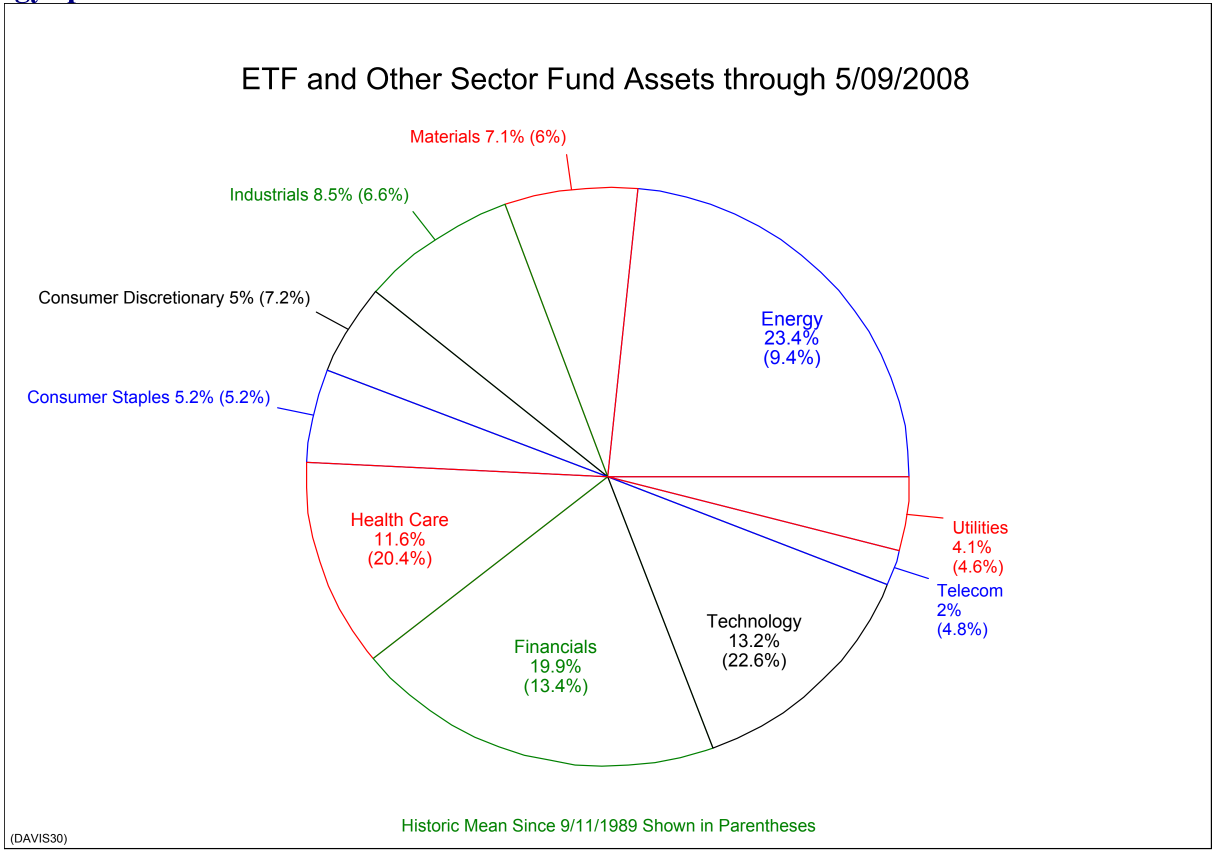
(S794)

2610
2208
1868
1580
1337
1131
957
810
685
579
490
415
351
297
251
212
180
152
129
109
90
80
70
60
50
40
30
20
10
0
-10
-20
-30
-40
-50
1984
1989
1994
1999
2004

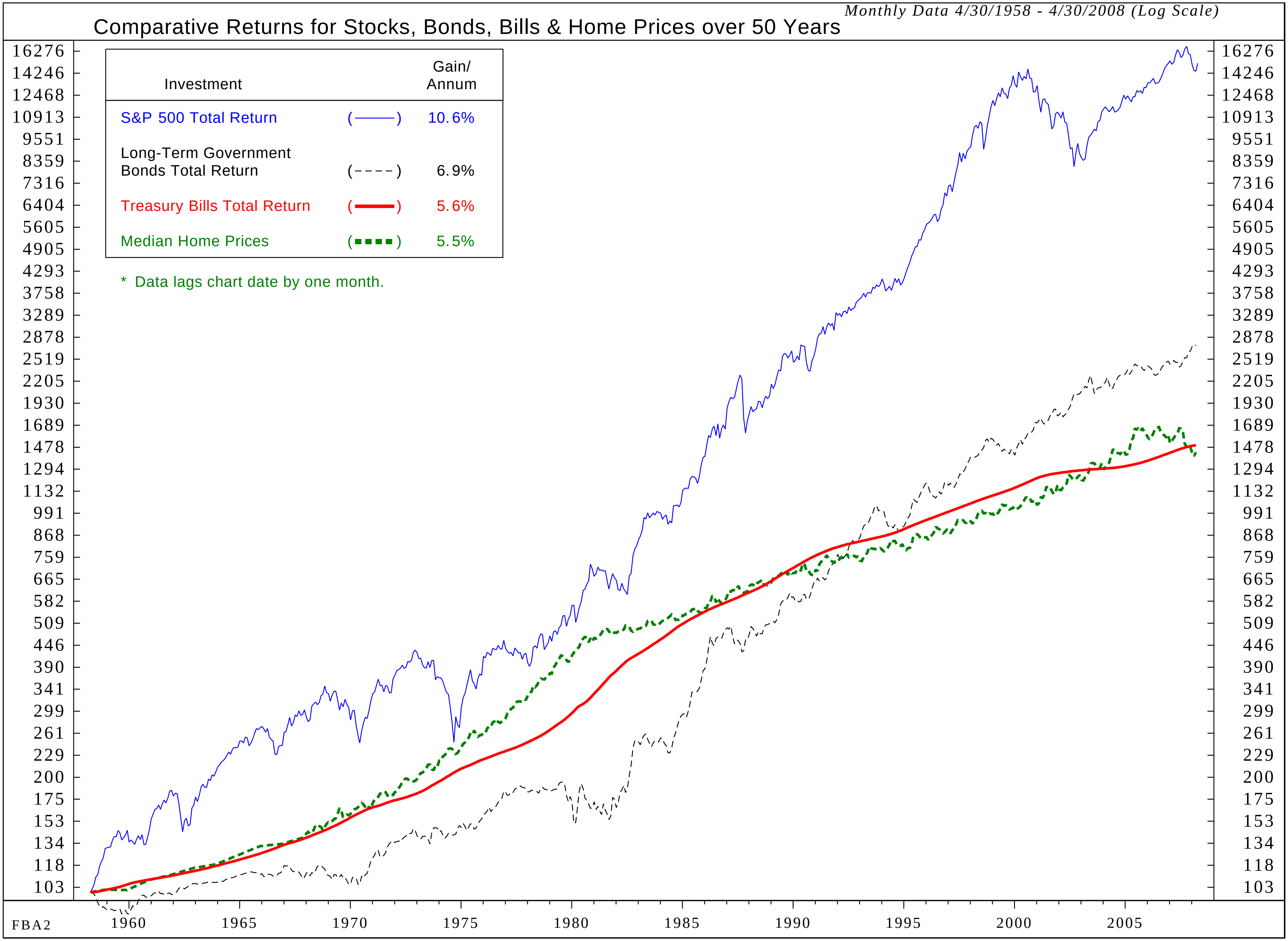
Chart Courtesy of Ned Davis Research

Holdings of Speculative Sector Fund Traders

Below is an up-to-date pie chart of the percent holdings in the 10 popular market sectors calculated by totaling the ETFs, 23.4% of all the assets are in energy-related funds, the most crowded of all 10 sectors, and just 2% are in Telecoms, the least crowded sector. Nevertheless, it is important to put these into perspective; so, in parentheses by each sector, we have what our analysis shows to be the historical mean for each sector. Since all the series do not start on the exact same date, the numbers in parentheses add up to slightly more than 100%. Nevertheless, the messages provided are very useful. Not only is energy, at 23.4% of all assets, the most crowded sector, but it is also well above its mean at just 9.4%. A reversion to the mean would be very painful to energy speculators.



Courtesy of Ned Davis Research, Inc.



Comparative Returns for Stocks, Bonds, Bills & Home Prices over 50 Years

Monthly Data 4/30/1958 - 4/30/2008 (Log Scale)

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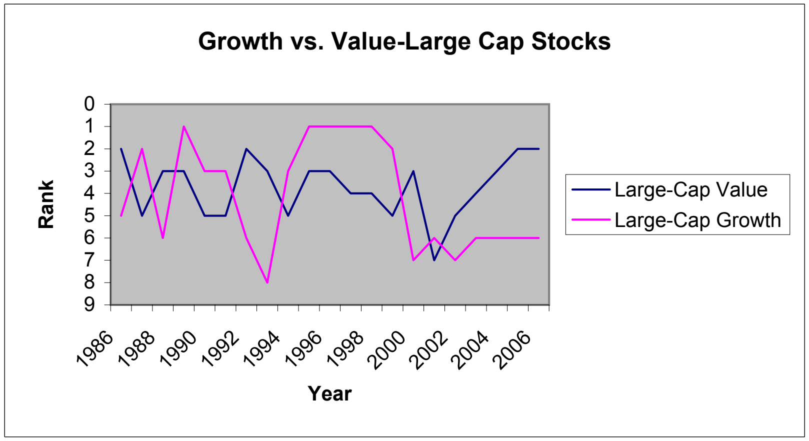
Investment Style Migration is Inevitable

Historical Returns Achieved by Various Asset Classes
Annual Returns Ranked in Order of Performance

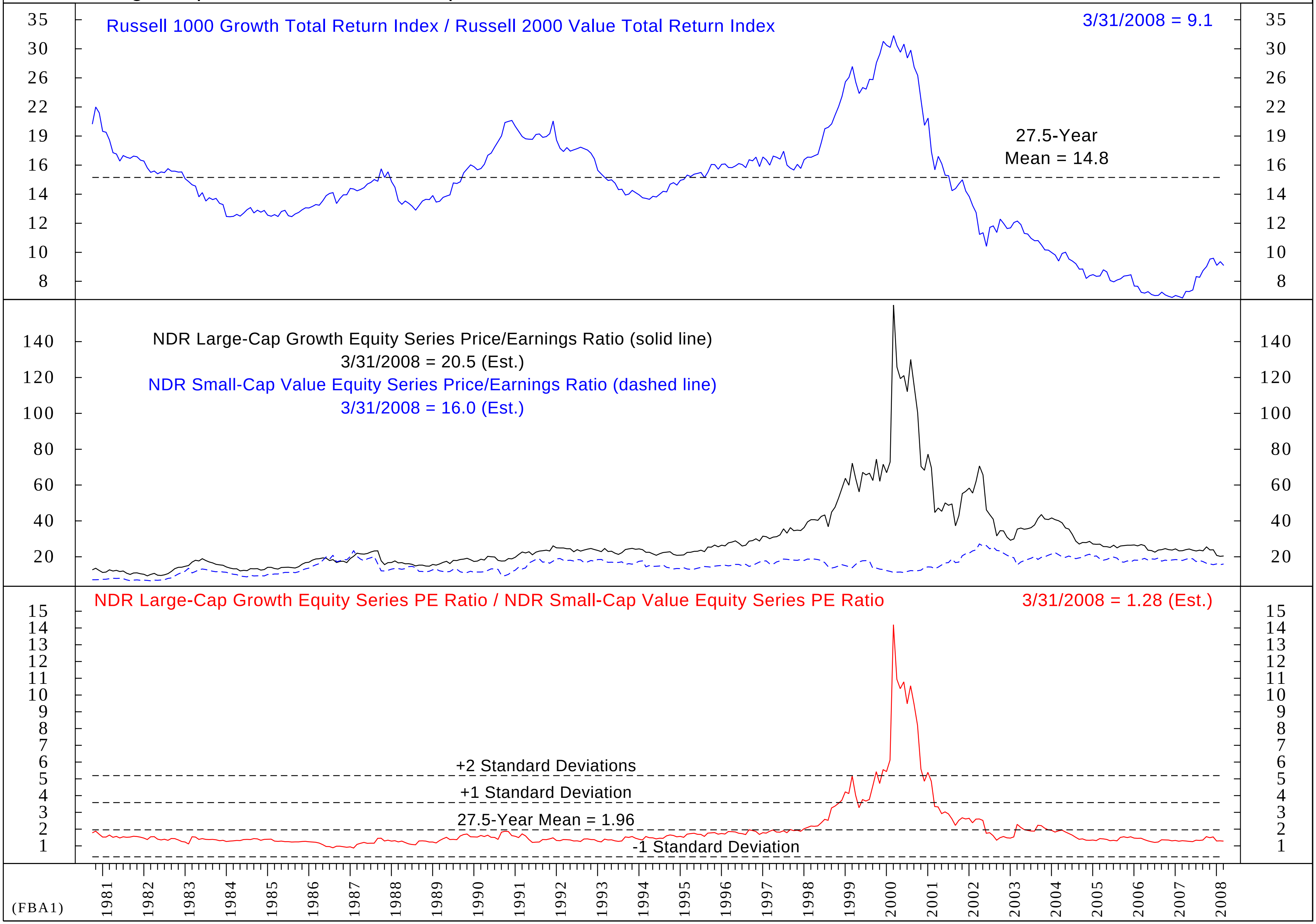
1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	YTD Thru 5/7/2008
Int'l 24.64%	Small Cap Value 29.47%	Large Cap Growth 36.40%	Fixed Income 8.96%	Small Cap Growth 51.19%	Small Cap Value 29.14%	Int'l 32.56%	Int'l 7.77%	Large Cap Growth 38.12%	Large Cap Growth 23.97%	Large Cap Growth 36.53%	Large Cap Growth 42.16%	Small Cap Growth 43.10%	Small Cap Value 22.80%	Small Cap Value 14.02%	Fixed Income 10.26%	Small Cap Growth 48.20%	Small Cap Value 22.10%	Int'l 10.90%	Small Cap Value 23.00%	Large Cap Growth 10.10%	Fixed Income 2.21%
Large Cap Growth 6.50%	Int'l 28.27%	Large Cap Core 31.68%	Cash 7.77%	Small Cap Value 41.70%	Large Cap Value 10.59%	Small Cap Value 23.84%	Cash 3.85%	Large Cap Core 37.58%	Large Cap Core 22.97%	Large Cap Core 33.37%	Large Cap Core 28.59%	Large Cap Growth 28.25%	Fixed Income 11.63%	Fixed Income 8.44%	Cash 1.78%	Small Cap Value 44.50%	Int'l 18.20%	Large Cap Value 5.70%	Large Cap Value 19.20%	Small Cap Growth 8.00%	Cash 1.06%
Cash 5.45%	Large Cap Value 21.67%	Large Cap Value 26.13%	Large Cap Growth 0.20%	Large Cap Growth 38.37%	Small Cap Growth 7.77%	Large Cap Value 18.60%	Large Cap Growth 3.13%	Large Cap Value 36.99%	Large Cap Value 21.99%	Small Cap Value 31.78%	Int'l 20.00%	Int'l 26.97%	Large Cap Value 6.08%	Cash 4.46%	Small Cap Value -13.20%	Int'l 35.30%	Large Cap Value 15.30%	Large Cap Core 4.80%	Int'l 17.70%	Int'l 7.90%	Int'l -3.40%
Large Cap Core 5.27%	Small Cap Growth 20.37%	Small Cap Growth 20.17%	Large Cap Core -3.10%	Large Cap Core 30.47%	Large Cap Core 7.62%	Small Cap Growth 13.36%	Large Cap Core 1.31%	Small Cap Growth 31.03%	Small Cap Value 21.36%	Large Cap Value 29.98%	Large Cap Value 14.67%	Large Cap Core 21.04%	Cash 5.86%	Small Cap Growth -9.23%	Int'l -17.50%	Large Cap Value 30.30%	Small Cap Growth 14.40%	Small Cap Value 4.10%	Large Cap Core 15.60%	Fixed Income 6.63%	Small Cap Value -3.70%
Large Cap Value 3.68%	Large Cap Core 16.60%	Fixed Income 14.54%	Large Cap Value -6.85%	Large Cap Value 22.56%	Fixed Income 7.40%	Large Cap Core 10.07%	Large Cap Value -0.64%	Small Cap Value 25.75%	Small Cap Growth 11.26%	Small Cap Growth 12.95%	Fixed Income 8.67%	Large Cap Value 12.73%	Large Cap Core -9.10%	Large Cap Core -11.76%	Large Cap Value -22.50%	Large Cap Core 28.70%	Large Cap Core 10.70%	Large Cap Growth 4.00%	Small Cap Growth 13.20%	Large Cap Core 6.10%	Large Cap Growth -4.40%
Fixed Income 2.77%	Large Cap Growth 11.95%	Small Cap Value 12.43%	Small Cap Growth -17.41%	Fixed Income 16.00%	Large Cap Growth 5.14%	Fixed Income 9.75%	Small Cap Value -1.55%	Fixed Income 18.47%	Int'l 6.04%	Fixed Income 9.68%	Cash 4.80%	Cash 4.60%	Int'l -14.16%	Large Cap Growth -13.96%	Large Cap Core -23.40%	Large Cap Growth 24.70%	Large Cap Growth 5.80%	Small Cap Growth 4.00%	Large Cap Growth 10.10%	Cash 5.10%	Large Cap Core -4.50%
Small Cap Value -7.11%	Fixed Income 7.88%	Int'l 10.54%	Small Cap Value -21.78%	Int'l 12.13%	Cash 3.55%	Cash 2.94%	Small Cap Growth -2.43%	Int'l 11.21%	Cash 5.03%	Cash 5.14%	Small Cap Growth 1.23%	Fixed Income -0.83%	Large Cap Growth -22.08%	Large Cap Value -14.71%	Large Cap Growth -24.50%	Fixed Income 4.10%	Fixed Income 4.34%	Cash 3.10%	Cash 4.87%	Large Cap Value 0.10%	Large Cap Value -6.00%
Small Cap Growth -10.48%	Cash 6.38%	Cash 8.21%	Int'l -23.45%	Cash 5.61%	Int'l -12.17%	Large Cap Growth 1.68%	Fixed Income -2.92%	Cash 5.54%	Fixed Income 3.61%	Int'l 1.78%	Small Cap Value -6.45%	Small Cap Value -1.49%	Small Cap Growth -22.43%	Int'l -23.39%	Small Cap Growth -30.70%	Cash 1.14%	Cash 1.30%	Fixed Income 2.40%	Fixed Income 4.26%	Small Cap Value -9.60%	Small Cap Growth -8.30%

		CAGR 88-07	CAGR 98-07
Cash	90 Day Treasury Bills	13.08%	8.63%
Fixed Income	Lehman Aggregate Index	7.54%	5.93%
Small-Cap Value	Russell 2000 Value Index	11.31%	5.56%
Small-Cap Growtl	Russell 2000 Growth Index	6.33%	6.41%
Large-Cap Value	S&P/Citi Value Index	11.74%	5.76%
Large-Cap Growt	S&P/Citi Growth Index	8.80%	4.30%
Large-Cap Core	S&P 500 Index	11.14%	4.23%
Int'l	Morgan Stanley Capital Int'l EAFE	4.54%	3.69%



Large-Cap Growth and Small-Cap Value Relative Valuation

Monthly Data 10/31/1980 - 3/31/2008 (Log Scale)



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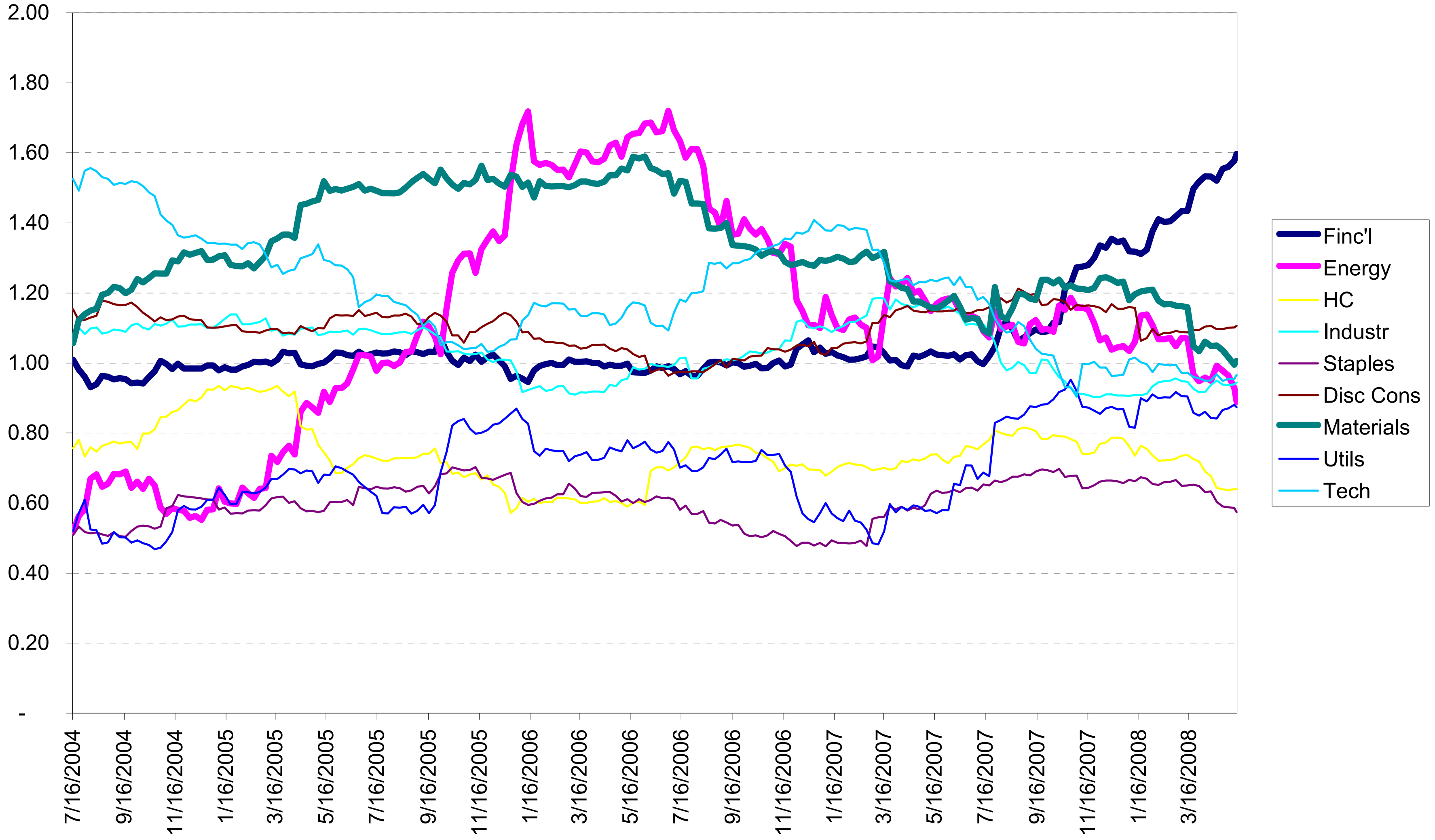
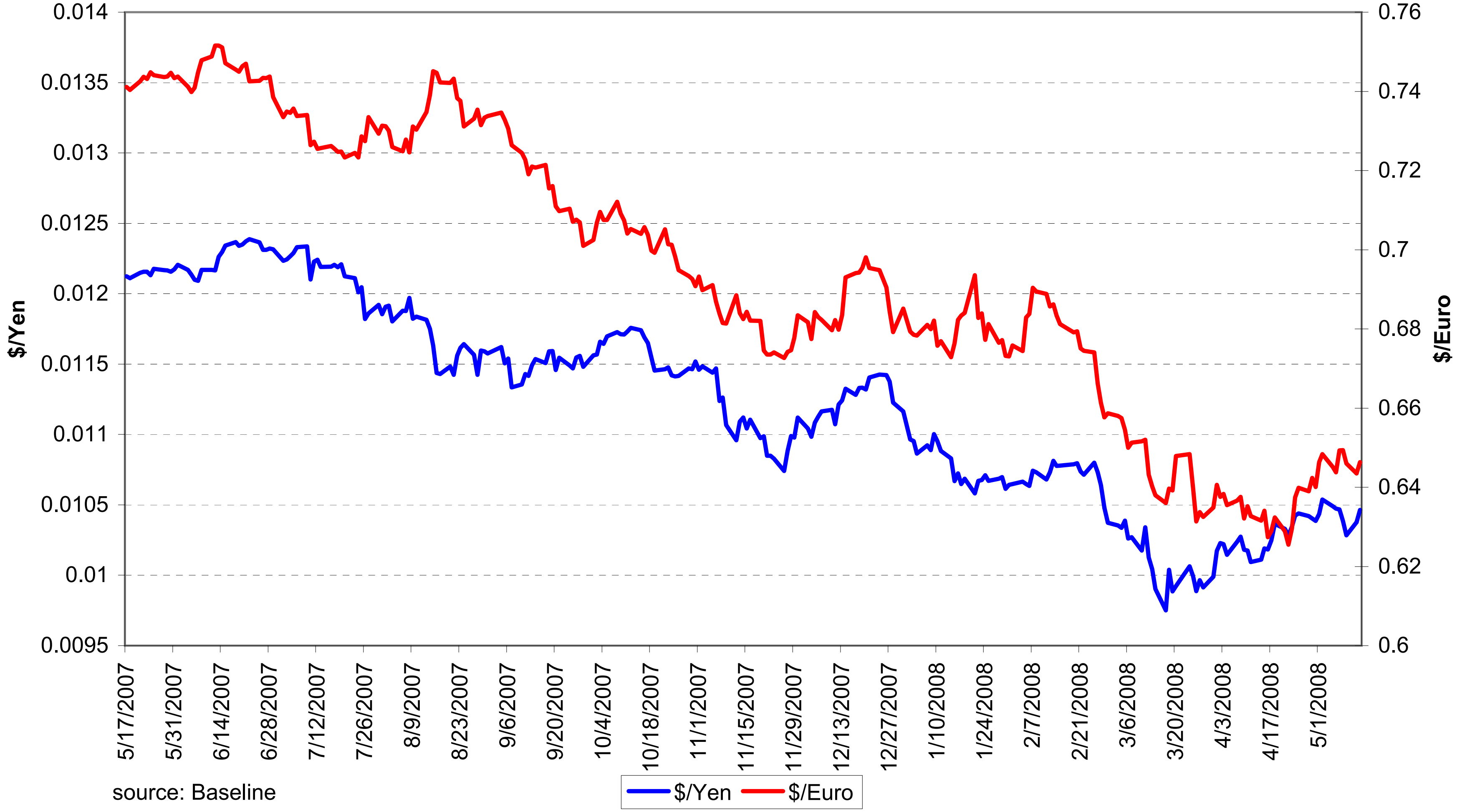
Sector Betas vs S&P 500

(60 weeks trailing at each date using SPDR ETFs vs S&P)



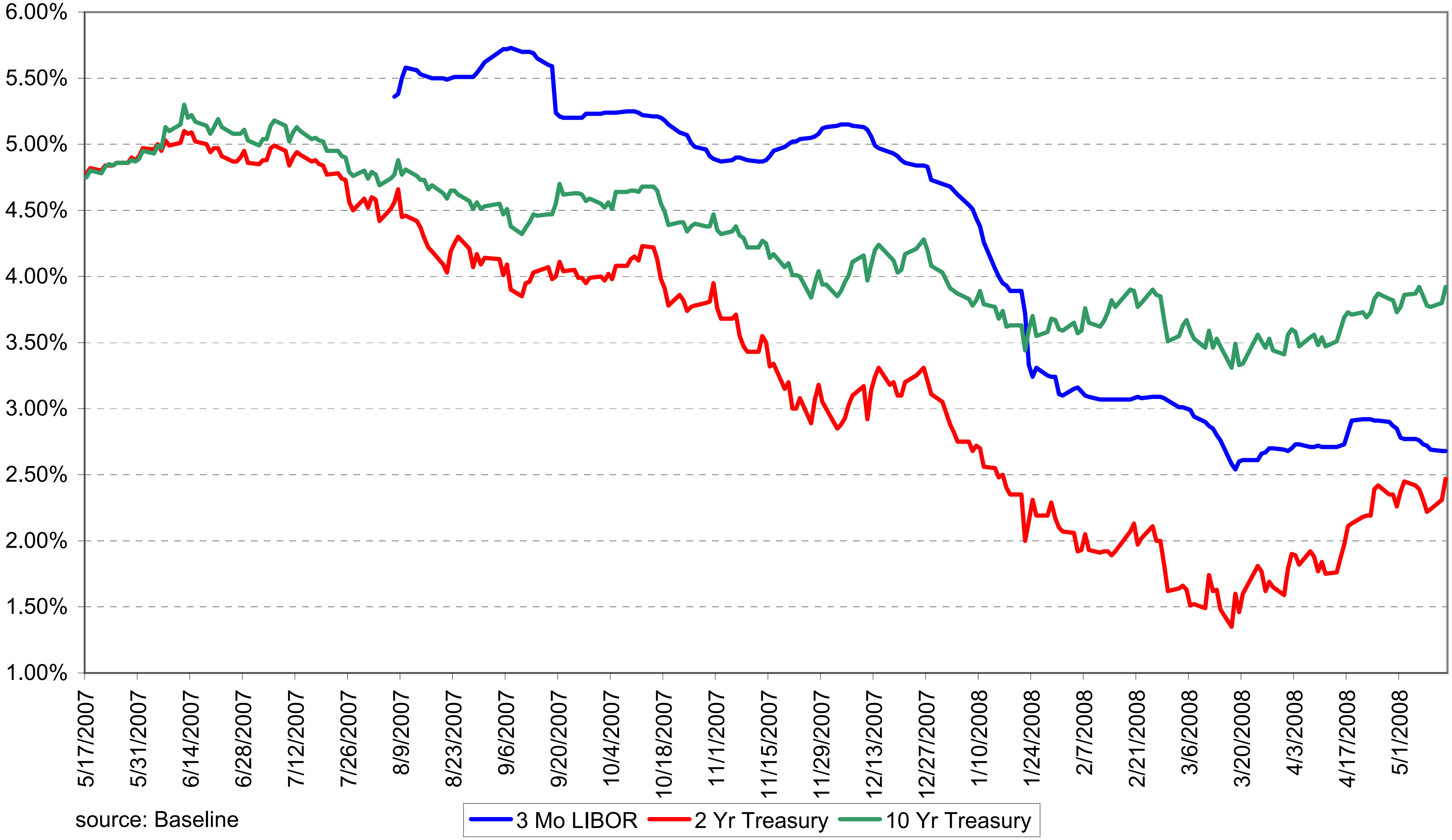
Dollar Rebound

US Dollar vs. Euro, Yen



source: Baseline

Rates Reversing



source: Baseline