MARKET LETTER

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First Quarter 2007

New Century, Subprime and the "Implode-O-Meter"

"You don't know who's swimming naked until the tide goes out."– Warren Buffett

Well … it was only a matter of time. After the Fed tapped on the brakes fully 17 times, taking interest rates from 1 percent to 5.25 percent, someone was bound to go through the windshield. The poster child for this cycle's most egregious example of excess is a so-called subprime mortgage lender -- Irvine, California based *New Century Financial.* New Century, a company that billed itself as "*A New Shade of Blue Chip*," may have chosen the wrong color. Freshly delisted from the New York Stock Exchange, it now trades in the paper junk yard otherwise known as the "pink sheets." After reaching an all-time high of $66 in December of 2004, it now trades at 87 cents. Bankruptcy is a likely option.

The market for subprime mortgage loans, or loans made to folks with poor credit histories, has unraveled with impressive speed and intensity. New Century is hardly alone. In fact, there's now a Web site dedicated solely to tracking this exercise in mortgage banking schadenfreude (www.mortgageimplode.com). As of this writing, they've counted 44 subprime lenders that have either gone bust or have entered some form of financial purgatory (there are about 8,500 mortgage lenders in the U.S.). In the past month, subprime lenders have either run into serious trouble (or shut their doors entirely) at an astounding rate of about *two per week*. Credit cycles always end this way, excesses are created and are often massive. Ultimately they are painfully purged. So taken at face value, and viewed through the prism of history, this credit cycle is not unique. Credit cycles sow the seeds of their own demise, and this cycle is no different.

Until very recently, the mortgage industry was awash in cash from investors searching for higher yields. This made it very easy for borrowers, *just about any borrower* ... to get a mortgage. Sometimes it seemed as though the only criterion for approval was the ability to simultaneously sign your name and fog a mirror. But rising defaults (no doubt sparked by steadily rising interest rates, and the expiry of so-called ultra-low "teaser" rates) soured investors' appetite for securities backed by these mortgages. This liquidity is (or was) the mother's milk of this risky slice of the mortgage banking market. Without the ability to "securitize" and sell these securities to investors, liquidity would evaporate and this virtuous credit cycle would ultimately grind to a screeching halt. As you might expect, the change at the margin has been most dramatic in some of the most superheated real estate markets. In parts of California, the proportion of seriously delinquent subprime loans has quadrupled in the past year to about one in eight.[1]

Wall Street is heavily involved with this liquidity cycle. The stock prices of both the larger commercial banks and the investment banks have gyrated in recent weeks amid concerns that many of these entities could find themselves exposed. Subprime loans made in 2006 totaled about $605 billion, or about 20 percent of the mortgage market, up from $120 billion, or 5 percent in 2001.[2] Subprime mortgages represent about 13 percent of all outstanding mortgages. During episodes like these, Wall Street's "cockroach theory" manifests. Investors rightfully anticipate that where there's one problem there can only be more. Until the full magnitude of the problem is exposed and fully discounted, investors … for the most part … vote with their feet.

More recently, these concerns have spilled over into the broader market, as investors worry about the ability of the U.S. economy to weather this storm. Will this sharp rise in defaults presage a

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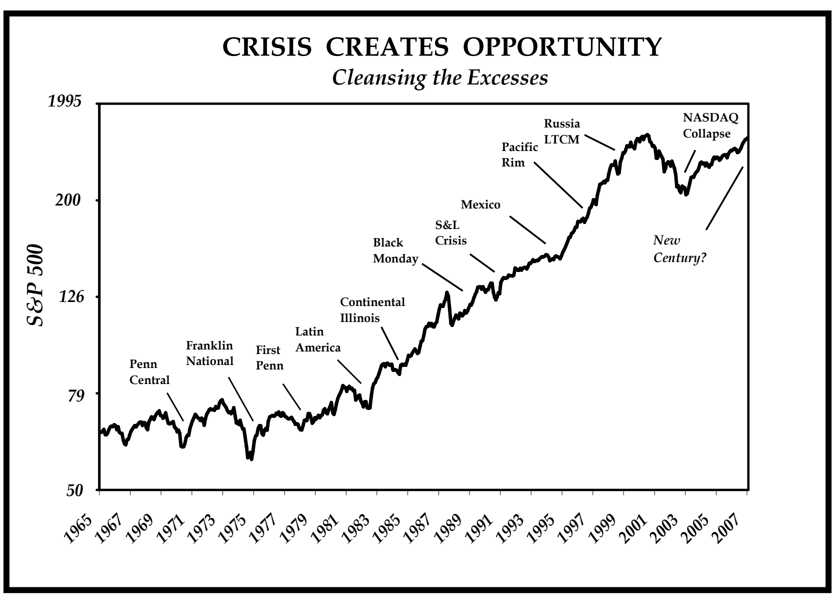
recession? More importantly, are our portfolios exposed in any significant way? What changes if any, have we made to lessen the impact from (or profit from) the fallout from this contagion?

While this gathering storm will most assuredly slow economic growth in 2007, we do not believe that it will induce a recession. Why are we so sanguine? For the most part, subprime borrowers tend to be less-affluent consumers. They make up a relatively small share of total consumer spending. The consumer is 70 percent of the U.S. economy, so to say that consumer spending is important is an understatement. However, the bottom fifth of U.S. households with the lowest incomes account for only 8 percent of all spending, while the most affluent fifth represents 40 percent of consumer spending. Unemployment remains low and incomes have been rising.[3] Both are strong contributors to the health of the consumers' pocketbook. While consumer spending will be negatively impacted, it will not fall off a cliff.

A larger concern is whether or not this subprime meltdown will produce a more generalized "credit crunch," a circumstance whereby investors and lenders generally pull back from all types of lending, both good and bad. These events have triggered recessions in the past, and these risks should not be taken lightly. However it does not appear to be happening this time. "Junk bond" yields (bonds issued by companies with risky financial structures), have actually narrowed since year-end (vs. Treasuries), and the troubles in subprime have not prevented the issuance of billions in new junk credit of late. Importantly, the subprime debacle has not infected the market for automobile related lending. Both consumers and businesses have ample access to credit, and a credit crunch does not appear to be materializing.

We expect that rising default rates will significantly increase the amount of supply of homes for sale. Prices will inevitably need to fall some more, perhaps precipitously in the most frothy markets. But this is a necessary part of this process of reaching equilibrium after one of the most pronounced housing booms in history. As we have stated in previous dispatches, we do not expect the residential housing market to crash. Rather, we believe this market is in a *secular, not a cyclical bear market*. That is, it will take many years before the generalized price levels established in recent years are decisively surpassed.

It is also important to note out that episodes like these can mark the end of the Fed's tightening cycle. Often accompanied by increased volatility and generalized share weakness, the behavior of the market can indeed act to force the Fed's hand. This has happened on numerous occasions, and is more the rule than the exception. It is very likely that we have seen the last rate hike for this cycle. Indeed the debate in the bond pits has now shifted from the timing of the next *tightening* to the timing of the first Fed *easing*. We share this



view, and importantly, our bond managers recently shifted their year-end target on the 10-year Treasury yield from 4.5 percent to 4 percent. While this may not be completely intuitive, it is not uncommon for stock prices to resume rising (often dramatically) once this paradigm shift has taken place.

We have reviewed our equity portfolios to gauge our exposure to this problem. We are watching three things: (1) any indications of direct subprime exposure, (2) write-offs associated with purchased loans, and (3) any evidence of increasing default rates in all credit categories. Our *Core Equity Model Portfolio* has no exposure to either regional or mortgage banks at the moment. We have also consistently underweighted the consumer discretionary sector. This sector would potentially be most negatively impacted by the travails of the subprime mortgage industry. Our bond portfolios are weighted heavily toward single "A" credits and higher. It is also important to point out that some of the strongest players (especially those with solid balance sheets), will undoubtedly purchase many of these distressed mortgage portfolios at a substantial discount. In fact, there are a handful of companies that reside in the finance sector of our portfolio that are very much poised to ultimately benefit from the demise of their weaker competitors.

In summary, the subprime mortgage contagion has unfolded with great speed and intensity. We have reviewed both our stock and bond portfolios for any direct exposure to this problem, and will continue to look for opportunities to profit through investment in the strongest players in this sector. While we believe that it will undoubtedly slow the economy in a meaningful way, we do not believe that the economy will enter a textbook recession. We believe that the Fed has finished tightening interest rates for this cycle, and we look forward to the first easing of credit sometime late in the year. Since the start of a new interest rate cycle often marks the bottom of a market cycle, we would not be surprised if stocks were to resume their rise once this issue has fully run its course. We will most assuredly continue to monitor these events as they unfold.

MARKET SUMMARY FIRST QUARTER 2007

- In response to fears of recession, the sell-off in equities and the associated market volatility in the quarter reached levels we have not experienced in years. Rather than marking the end of a bull market, we view this as a mid-cycle slowdown.
- Despite lingering concerns over inflation, we believe that the Fed has finished tightening interest rates for this cycle, and we look forward to the first easing of credit this year.
- Since the start of a new interest rate cycle often marks the bottom of a market cycle, we would not be surprised if stocks were to resume their climb in anticipation of a more accommodative Fed and lower interest rates.

Footnotes:

1. *First American Loan Performance.*
2. *Inside Mortgage Finance.*
3. James Hagerty, "Second-Biggest Subprime Lender Halts New Loans," *Wall Street Journal*, March 9, 2007.

Sources:

1. James Hagerty, "At a Mortgage Lender, Rapid Rise, Faster Fall," *Wall Street Journal*, March 12, 2007.
2. Mike Spector and Mark Whitehouse, "The Outlook: Subprime Fallout May Not Infect Broader Market," *Wall Street Journal*, March 12, 2007.

PROFESSIONAL PROFILE – JAMES A. COATS

Ferguson Wellman's new vice president of business development is Jim Coats. He's charged with cultivating new client relationships, especially in areas where the firm is looking to grow. Coats blends his experience in sales – including stints on Wall Street and in international business – with the personal approach favored at Ferguson Wellman.

"I get to know people in the community," says Coats of his strategy, "including key influencers like accountants and tax and estate attorneys. From there I meet individuals and families who we may be able to help. I also introduce myself to institutional investment consultants, so we can be on their radar when their clients are conducting an investment manager search."

Jim Coats with wife Melinda and children Mia and James

As an undergrad he earned a BA in communications from Oregon State University, with a minor in Mandarin. "I grew up in Portland's East County and went to Reynolds High School," he says, a bit puzzled, even now, to explain how he gravitated to the Chinese language. "But my family always had an interest in things Asian. My father was a dentist in the army in Korea, and my mother taught Japanese and Thai cooking." During college Coats did a study aboard program in Beijing and traveled all around the country. Upon graduating, Coats returned to China to teach English at the Shanghai University of Finance and Economics.

Back in the U.S., Coats took a sales position with the global steamship carrier Maersk Line in Seattle. "I wanted to be involved in business related to China," he notes. He spent five years in Seattle, then moved to New York to pursue a master's degree in international affairs, with a concentration in international finance, at Columbia University. Upon graduation he worked as a hedge fund index product manager and business development associate at Morgan Stanley Capital International. "There was no better place than New York to cut my teeth in finance," says Coats. But after three successful years there – during which he developed a new hedge fund index he sold nationally for Morgan Stanley – Coats and his wife, Melinda, were ready to return to Portland. "Our daughter Mia was born in 2002," he recounts, "and we wanted to get back here, to grow our roots again. Plus," he laughs, "it's hard to raise a child in New York … it seemed like every day she got bigger and our apartment got smaller!"

He accepted an associate consultant position at R.V. Kuhns & Associates, which brought him back to Portland, but Coats missed business development. "It's just more my cup of tea," he says. When the Ferguson Wellman position popped up, in the spring of 2006, he jumped at the chance. "The culture here is second to none," he says with a happy sigh. "It's a collaborative, team-oriented place and there's mutual respect up and down the ranks."

Melinda, who holds a master's degree in social work from the University of Chicago, has her hands full these days with Mia, now a four-year-old preschooler, and James, 21 months. The couple has settled in Raleigh Hills.