SPECIAL REPORT

An Annual Publication of Ferguson Wellman Capital Management

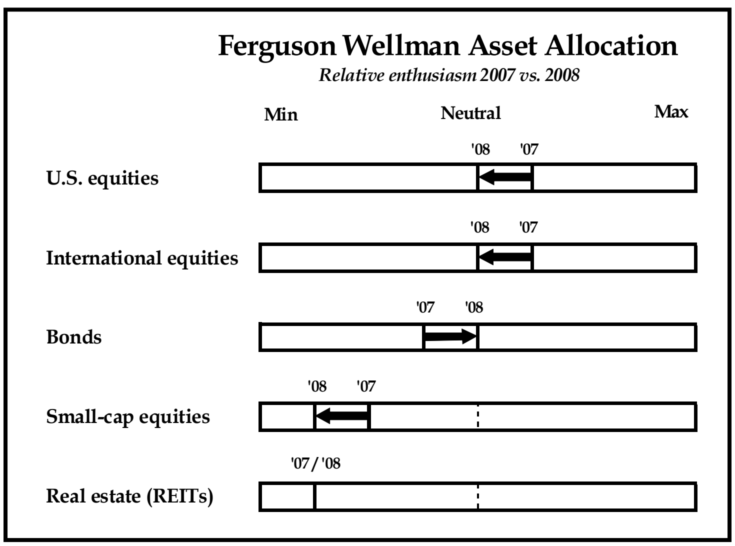
Outlook 2008

Investment Policy Committee

by George Hosfield, CFA

Though our expectations for a wide divergence between the returns of the primary asset classes proved to be correct last year, in 2008 we anticipate that the return differentials between asset classes will be materially compressed.

Specifically, with both long rates and the dollar perhaps probing for a bottom, slowing global growth, and the domestic economy flying at "stall speed," we anticipate that large-cap domestic equities, international equities and investment grade bonds will perform much as they did last year. That is, we expect volatility to remain at elevated levels, but with a generalized upside bias. In that context, we are forecasting mid-single-digit returns for the year. At this juncture, whether we enter a textbook recession in 2008 is more of an academic question than an investment issue. In this regard, our primary concern is determining what impact the slowing pace of economic growth will have on corporate earnings and interest rates. In recognition of this heightened risk to the economy, we are modestly reducing our allocation to equities and increasing our commitment to fixed income securities. Much like last year, we believe that both small-cap equities and REITs lack a sufficient catalyst to warrant the allocation of additional capital at this time. With comparatively little exposure to international sales, small-cap equities should benefit little from the ongoing growth in international markets. While REITs sold off materially in 2007, we believe it is still too early to make additional commitments to REITs. However, as we approach the second half of the year, this asset class may afford a compelling total return opportunity.



Possible Capital Market Catalysts

- U.S. avoids recession
- Continued global growth
- Low interest rates
- Contained inflation
- Abundant global liquidity
- Low unemployment

Capital Market Risks

- Significant housing recession
- Commodity inflation
- Stagflation
- Banking credit crunch intensifies
- Material decline in earnings

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OUTLOOK 2008

MARKET LETTER

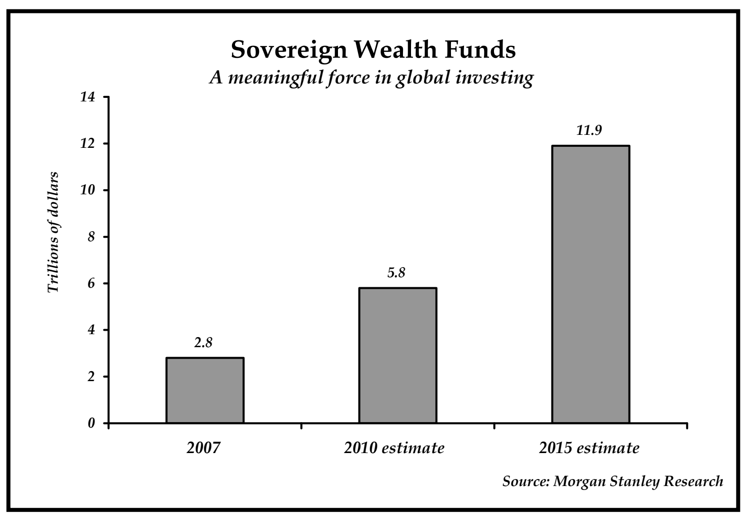
FOURTH QUARTER 2007

Hurricane Hunters BY DEAN DORDEVIC

Several months ago, we were asked to characterize the current market environment as it relates to the subprime swirl around us. We offered up a metaphor that has since served as an eerily accurate forecast. We compared the current period to one of those *hurricane hunter* – weather channel TV episodes – whereby those large lumbering aircraft (with very brave folks aboard) routinely fly through the worst of these storms.

The leading edge (market in mid-July) was the worst and most violent. The "eye" was calm, almost peaceful, and usually sunny (market in early fall). Flying through the trailing edge (our current position) while not quite as bad as the initial leading edge experience, is quite harrowing to say the least. We think we're flying through the last of it right now. When we fully exit is anyone's guess, but hopefully more of this subprime mess is behind us than in front of us.

Anyone who has read a newspaper or watched CNBC is well aware of the negatives. To wit: bank stocks have had their biggest decline since the 1990 recession. Consumer confidence is falling, and the Homebuilders Index is at or near a record low. More than 75 percent of Americans say the U.S. economy is getting worse.



With all this bad news, it is somewhat surprising that the broad averages are trading within *10 percent of an all-time high*. We believe that there are several reasons why there is a reasonably firm underlying "bid" for stocks. With bankers on the run, and credit conditions tightening, (to be sure) the U.S. economy is feeling the effects. While this is true in the "real economy," there is another side to the liquidity story that should not be ignored nor underestimated.

Hedge funds, private equity, sovereign wealth funds ($4 trillion and counting), corporate liquidity, and global money supply growth ... all remain very robust. Despite the extreme volatility of late, investors have not withdrawn from these funds. In fact, these large pools of liquidity have actually expanded. Anecdotal evidence of the cashflow phenomenon occurred late last year when the big box retailer Target Corporation reported quite disappointing quarterly earnings. While this was hardly a surprise, what was indeed a surprise was their announcement that they would repurchase 20 percent of their shares in the open market. Amazing.

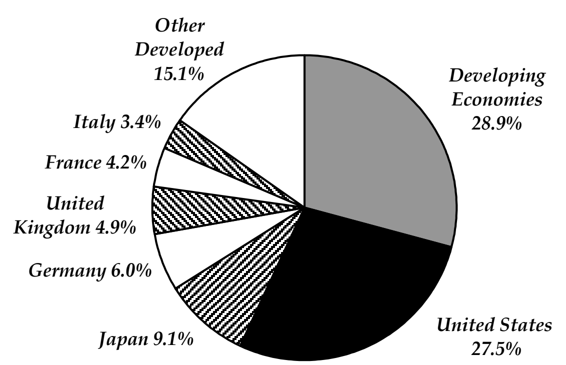
The newest and most intriguing pool of global money is oil related. At current per barrel quotes, OPEC nations will earn nearly $700 billion this year. This translates into roughly $5 billion worth of petrodollars to invest *every week*. Citigroup was the most recent beneficiary of this largesse, with the Abu Dhabi Investment Authority becoming one of the largest investors in their company with a $7.5 billion investment. While investors from the Gulf States have historically favored U.S. Treasury debt as investments, the boom in oil prices has encouraged oil producers to set up so-called "sovereign wealth funds." "The oil producing countries simply cannot absorb the amount of wealth they are generating," said J. Robinson West, chairman of PFC Energy. In addition, the explosion in petrodollars has enhanced global liquidity at a time when the foreign currency reserves of export driven economies in Asia are also flush with cash.[1]

In our opinion, the anchor under the global stock market is twofold: (1) the global growth story and (2) abundant liquidity. While the U.S. economy is slowing in large part from the impact of imploding residential real estate (subtracting 1 percent from GDP), the boom in exports (a 1 percent addition to GDP) has *completely offset* the lagged impact of this recession in real estate. In addition, for quite possibly the first time, the U.S. economy is *benefiting from a not insignificant tailwind of global growth and rising prosperity* (principally in the developing world). In fact, in previous cycles, the developing world's economic growth would have *already turned vicious*. In other words, when the U.S. economy softened, in most previous cycles, capital was repatriated and emerging markets virtually collapsed. This has not happened this time. In fact, emerging market economies are (for the most part) self-financing their growth, quite possibly for the first time ever. Bottom line, the developing world collapse that normally accompanies a U.S. slowdown (or recession) doesn't appear to be happening.

While we're quite sure the rest of the world is also slowing, global growth is slowing from rates of growth that are high enough that generalized recession will likely be avoided. At present, there are 120 countries whose growth rates are in excess of 4 percent. Additionally, when taken in the aggregate, emerging market economies have recently *surpassed the U.S. in terms of their share of the global GDP pie*.

We believe that the equity market will remain very volatile. We also believe that while U.S. GDP growth will slow, a generalized recession will be avoided. Strategically, we have deemphasized those sectors where the fallout from economic weakness is greatest (the consumer, finance, banking), and we have moved capital into those sectors that are the primary beneficiaries of global growth (energy, materials, industrials).

The Mix of World GDP 2006



Source: ISI Group

Another way to think about our stance is this: What the developing world *imports they inflate*. What the developing world *exports they deflate*. Our portfolios are geared to profit from that trade, and we envision maintaining our current stance … for now. However, inevitably there will be opportunity were there is now only pain. Stay tuned!

Source:

1. Steven Weisman, "Oil Producers See the World and Buy it Up," *The New York Times*, November 28, 2007.

ASSET CLASS OVERVIEW

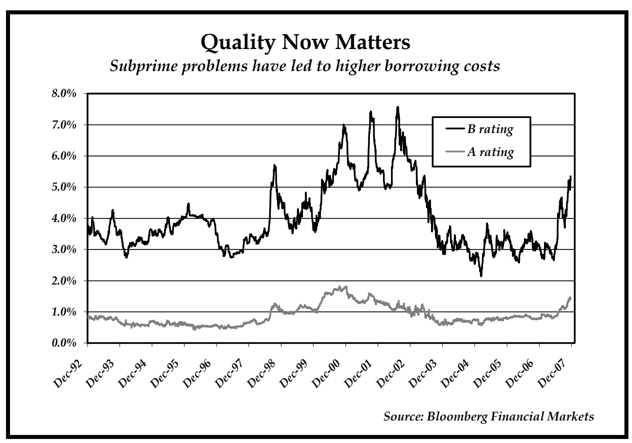
Domestic Equity BY GEORGE HOSFIELD, CFA

With economies of more than 120 countries growing in excess of 4 percent and the dollar essentially putting America "on sale," large-cap equities remain competitively positioned relative to small-cap equities. As we enter 2008, our meaningful commitment to global, cyclical shares (industrials, energy, basic materials, technology) and our lack of enthusiasm for the consumer and financial sectors continues to drive our domestic allocations. However, if the domestic economy weakens further, investors will likely place a premium on earnings growth/stability. If such a slowdown should occur, then we will most likely rotate capital toward more traditionally defensive growth sectors such as consumer staples, utilities and healthcare. As the economy walks the fine line between slow growth and recession, we shall be closely watching the economic data for evidence of an inflection point.

Equity Income BY JASON NORRIS, CFA

Our *Equity Income* discipline is unique in the respect that we focus on companies with growing dividends and cashflows, rather than simply high yielding stocks. The result is a more robust discipline than many pedestrian value/income approaches. While 2007 proved difficult for many value and income strategies that were hurt by the crisis within the financial services sector, we were able to navigate through by focusing on stocks outside banking, while still maintaining a dividend yield close to 4 percent. In 2008, we believe dividend yield will be more of an important component of total return. We also anticipate increasing our exposure to the financial services sector as we approach the later innings of the credit crisis. However, though valuations and dividend yields are now attractive, fundamentals are still weak, and our transition to financials will be slow and selective.

Fixed Income BY MARC FOVINCI, CFA AND MIKE KNEBEL, CFA



Source: Bloomberg Financial Markets

The subprime quagmire and high oil prices are weighing heavily on investors' minds. On top of slamming the brakes on the residential real estate market, the subprime problem has tightened credit in general, affecting both publicly traded bonds and bank lending. As shown by corporate bond yields spreads in the accompanying graph, the price of credit is higher everywhere. However, some of the weight of oil and credit on the economy has been counterbalanced by the improving trade deficit. In short, the weak U.S. dollar is lifting our exports and thus helping our GDP. While we believe the economy will avoid recession, we expect somewhat wider credit spreads and modestly lower Treasury bond yields until the effects of subprime are largely flushed through the system. To this end, the negative news will likely slow down by June of next year when the bulk of the write-offs are hopefully completed. Until then, the Fed should continue lowering rates. At this juncture, we prefer the quality afforded by Treasuries and agencies, and are underweight mortgage-backed securities. We remain vigilant in ensuring the quality of the corporate bonds that we hold. With market pessimism increased, we are maintaining an extended average portfolio maturity and duration.

International Equity BY RALPH COLE, CFA

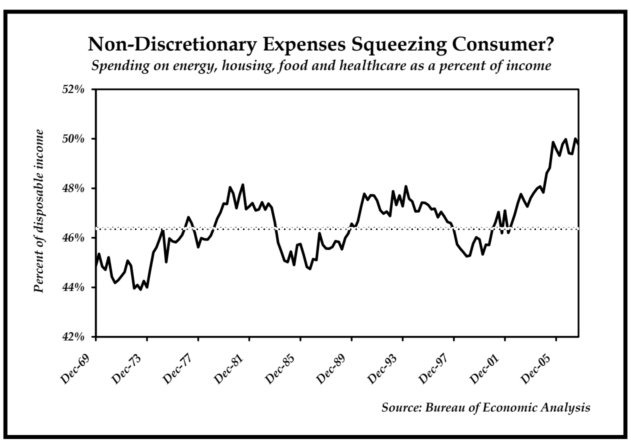
A weak U.S. dollar and rapidly growing economies in emerging markets remain the primary international stories as we enter 2008. Last year, from China to Brazil, we increased the portfolio's exposure to faster growing areas of the world, and we envision more of the same in 2008. The most disappointing area of the globe continues to be Japan. We were hopeful that Japan had placed itself back on a growth path early in 2007, but unfortunately this proved to be another false start. Excluding Japan, we remain overweight Asia and the emerging markets in our international portfolios. Furthermore, we believe the highly anticipated slowdown in the Chinese economy post the 2008 Olympics may provide an opportunity to add to our Chinese positions.

Real Estate Investment Trusts (REITs) BY RALPH COLE, CFA

We have been wary of the sector for two years running. While we exited REITs before their peak in 2006, our posture was rewarded handsomely in 2007 when the overvaluation in this asset class corrected dramatically. In fact, for the first time since 1999, REITs underperformed all other major indices last year. Our expectations are for sluggish economic growth in 2008, which should present weaker industry fundamentals. We continue to favor companies with emphasis in lodging, industrial and office space. Foreign interest in U.S. real estate remains high, which should provide some support for prices. Despite our current pessimism, we may begin to commit more capital to this sector in 2008.

EQUITY SECTOR STRATEGIES

Consumer Discretionary BY GEORGE HOSFIELD, CFA



Twelve months ago when authoring this very piece, we opened by stating, "Given the combined effects of higher energy prices, an anticipated upward interest rate reset for many adjustable rate mortgages and a substantial decline in mortgage equity withdrawals, in general we are not enthusiastic about the prospects for this sector." Our pessimism was warranted as the aforementioned economic headwinds only intensified for the consumer. Apart from financials, this was the worst performing S&P sector in 2007. Though the beleaguered retail, auto and housing related stocks could very well fall to a point that they are too cheap to ignore in 2008, our strategy remains unchanged at this time. To that end, we continue to avoid those companies most exposed to the low-end consumer, and instead, focus on industries with favorable demographics, and solid cash flow generation such as media and leisure.

Consumer Staples BY LORI FLEXER, CFA

The performance of the consumer staples sector in 2008 will in part be influenced by further investor fears of recession. Classically defensive, these stocks have provided investors with a relatively safe place to hide during market uncertainty. We anticipate this volatility will continue until the economic slowdown versus recession question becomes clear. However, the defensive nature comes at a valuation "price," because the group currently trades at a healthy premium (20x PE versus 15x PE) to the S&P 500. Many names in the sector, and in our portfolio benefit from the weak U.S. dollar and a global footprint. Somewhat offsetting these tailwinds are persistent high raw material and commodity costs, which serve to pressure margins and profitability. Continued global demand is expected to result in estimated earnings accelerating from 8 percent in 2007 to 11 percent in 2008. Bottom line, we anticipate this sector will enjoy a return in-line with its underlying rate of earnings growth.

Energy BY MARK KRALJ

The best indicator of oil prices in 2008 will be the rate of global economic growth. The most significant influence on oil prices moving higher in each of the last four years has been the strong demand emanating from developing countries (China). This spurt in energy usage from developing countries has created a supply/demand crunch that has served to push prices higher. Adding to upward price pressure is the fact that much of the new supply of oil comes from countries with political instability, or just a desire to make Western countries "pay up" for the oil. With the possibility of geopolitical conflicts, weather-related disruptions and refinery outages, further price spikes are certainly possible. Prices certainly could drift lower, but unless we enter a pronounced economic slowdown, they should be supported at a $65 to $70 per barrel floor. However, the upside can be significantly higher, including triple digits, if subjected to the types of risks listed above. As such, we remain positive on this sector.

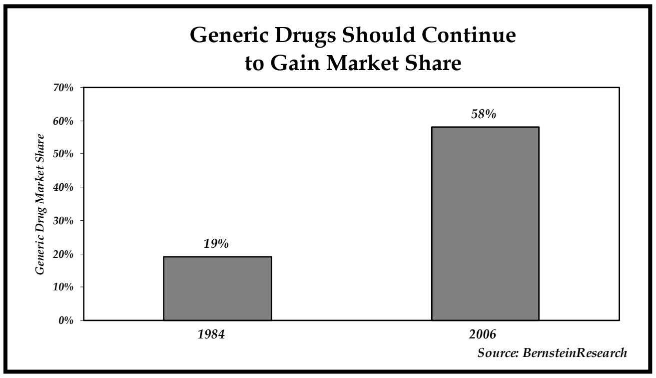
Financials BY RALPH COLE, CFA

Subprime, CDOs, and SIVs were only a few of the terms Wall Street (and Main Street) became acquainted with in 2007. The first cracks in the home lending market surfaced in late February when HSBC announced record losses in its subprime mortgage lending unit. HSBC indeed was the "canary in a coal mine." Write-offs and announcements have flowed steadily since late summer, and literally brought the U.S. credit markets to its knees. With this backdrop, we placed increased emphasis on downside protection in the companies that we have owned. While virtually all stocks went down in this sector during 2007, we dramatically outperformed the benchmark. Specifically, we were devoid of regional banks, consumer and mortgage-related companies throughout the year, and instead we emphasized companies that are leveraged to insurance and capital markets. We have been waiting for additional write-offs, and slightly lower valuation levels before increasing our weighting in this sector. We think the worst of the write-offs will be behind us once banks report their year-end results. As such, late in the first quarter may provide an opportunity to commit capital to a cheap sector.

Healthcare BY DEAN DORDEVIC

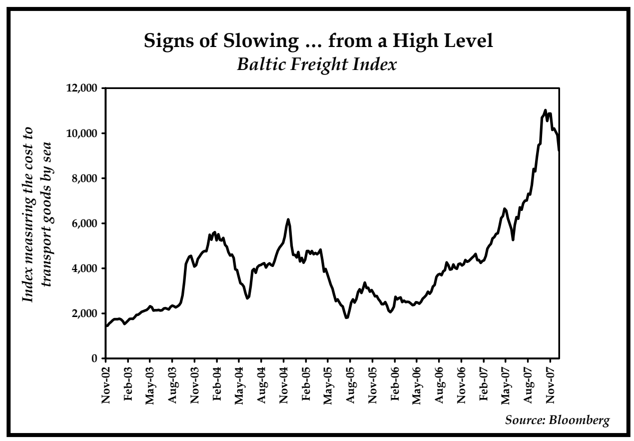
We view the healthcare sector with more caution than we did last year. With the 2008 election less than a year away, we believe that there is increased risk (both political and fundamental) to the sector.

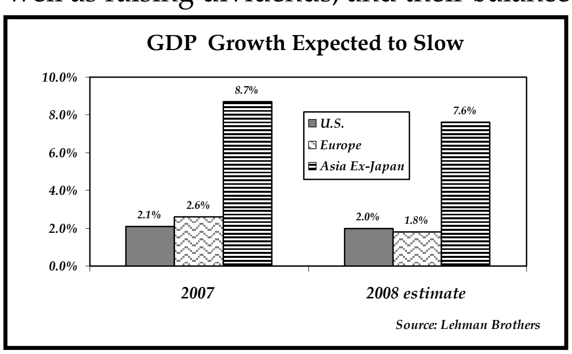
Large-cap pharma holds the most risk due to continuing rhetoric of government controlled healthcare, as well as further generic drug competition. In this area we are emphasizing companies with below average generic competition, as well as above average pipeline opportunity. While we are underweighting the pharma side of healthcare, favorable demographic trends have caused us to emphasize the medical technology industry. Though the sector remains attractive due to valuation and its global exposure, we still believe it merits a slight underweight due to the political risks, and generic competition. As such, we will continue to focus on companies in medical technology and equipment.



Industrials and Materials BY JIM RUDD

These late-stage, cyclical sectors have benefited greatly from the industrialization and infrastructure build that is occurring in virtually all developing economies throughout the world. While a slowing U.S. economy still directly impacts this sector (railroads and airfreight), there are many industries (conglomerates, defense, aerospace, machinery, electrical components) that are leveraged to faster growing economies outside the U.S., where a weak dollar also provides a competitive advantage. Virtually all of the companies we own have a number of attributes in common. Namely, a majority of their sales are abroad, their foreign sales have better margins than their domestic sales and their foreign earnings are growing more rapidly than their domestic earnings. In general, companies in this sector have been aggressively repurchasing shares as well as raising dividends, and their balance sheets remain solid. Favored industries include: defense/aerospace, machinery (industrial, construction, farm), electrical components and conglomerates.



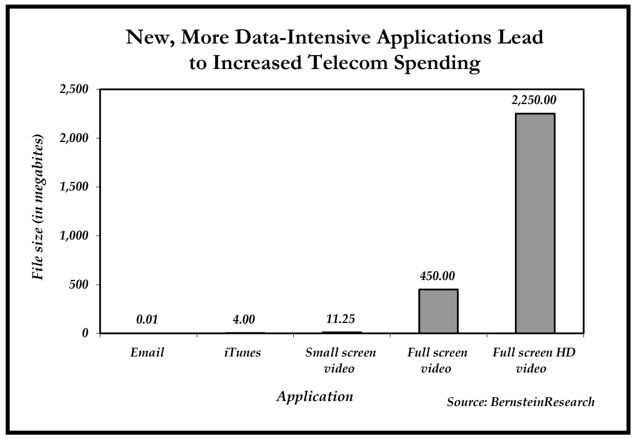


Commodity stocks outperformed the S&P 500 in 2007 due to strong global demand and pricing, as well as merger and acquisition activity. Driven by emerging economies (which now surpass the U.S. at 30 percent of world GDP), commodity prices remained elevated due to robust global demand. China specifically, which is 6 percent of world GDP, continues to grow at a double digit pace, thus fueling the need for a broad range of commodities, such oil, aluminum, copper, coal, etc. Even though China's growth may slow, the lack of new supply for most commodities should keep prices higher, longer. The favorable fundamentals won't last forever, but we believe it will continue throughout 2008.

Since global growth is expected to decelerate in 2008, we will focus investments in companies levered to global growth, as well as those experiencing more "secular" growth. We are closely watching macroeconomic indicators such as the Baltic Freight Index as an indication of the pace of global output. While this index remains strong, it is showing some weakness, which supports our belief for slower global growth in 2008.

Technology BY JASON NORRIS, CFA

After lagging the S&P 500 for several years, 2007 was finally a rewarding year for technology investors. Corporate and telecom capital spending as well as strong product cycles led to tech's outperformance. Looking ahead to 2008, we anticipate this to continue as the result of strength in corporate cashflows, as well as "broadband/data" growth. With more consumer and business applications being transported wirelessly and much more data intensive, the demand for infrastructure to enable and transport this data will be key (see graph).



This thesis has motivated us to emphasize the networking and telecom equipment industries. However, as the U.S. economy slows, consumer and business spending may slow, thus leading to slower growth in the technology sector. If this environment should unfold, we will focus on companies with less direct exposure to discretionary business and consumer spending (especially those with exposure to the financial sector).

Telecommunications and Utilities BY STEVE HOLWERDA, CFA

Following a solid performance in 2007 that surpassed our expectations, we remain constructive on telecommunication stocks. Given the relatively low interest rate environment, a sector dividend yield in excess of 3 percent, and strong cashflow for the companies, telecom stocks afford a compelling total return alternative. The utilities sector also provided impressive returns in 2007 as interest rates fell and economic growth decelerated. As investors wrestle with the magnitude of the global slowdown, utilities should offer a defensive area in which to invest. We recently increased our allocation to this sector to "neutral," and it was only relatively high valuations that have kept us from being more aggressive on utilities. Within the sector, we are positive on the deregulated utilities that are primarily focused on nuclear generating assets. While the yield is lower than the average utility stock, we believe the growth dynamics offer a compelling long-term investable theme.