SKY INVESTMENT GROUP

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To: Our Friends and Clients

From: Robert Bingham, CFA
SKY Investment Group LLC

Re: Third Quarter 2007 - Review and Outlook

"Only buy something that you'd be perfectly happy to hold
if the market shut down for 10 years."
-Warren Buffett

Despite the turmoil in the credit markets this past summer, stocks finished the quarter on a strong note, with the S&P 500 returning 2.03% for the quarter (including dividends), bringing full-year total return to 9.13%. The blue-chip Dow Jones Industrial Average closed even stronger, returning 4.19% (including dividends) as risk-averse investors rotated into quality companies with strong financial characteristics. Year-to-date, the Dow has returned 13.31%. Even the tech-heavy Nasdaq Composite advanced, as investors pursued growth in still-cheap, financially strong, large-cap tech names like Cisco Systems and Oracle. The Nasdaq closed the quarter having advanced 3.98% (including dividends). Year-to-date, the Nasdaq has returned 12.48%.

Bond market returns were more variable. High-grade corporate and government bonds rallied as investors sought safety from the turmoil in the low-grade and mortgage-backed securities sectors of the debt markets. The Merrill Lynch U.S. and Corporate 5-10 Year Index of Bonds A-Rated and Above advanced 3.56% for the quarter. Investor concern about the ability of high-risk mortgage holders to meet their obligations caused a lock-up in the market for mortgage-backed bonds. For example, the Merrill Lynch CMBS Fixed Rate BBB-Rated 10+ Year Index fell 6.99% for the quarter bringing full year returns to -11.20%. Since the market is quite large and mortgage-backed debt is widely held, investors balked at buying both the mortgage-backed bonds and the debt of entities that owned them. The fact that disclosure rules are inadequate to allow investors to promptly assess the creditworthiness of bond issues and their issuers only made matters worse. We suspect that the last chapter of the mid-summer mortgage meltdown has yet to be written.

Review and Outlook

At an unscheduled meeting on August 17th, the U.S. Federal Reserve lowered the Discount Rate by ½ a percentage point to 5.75% to help ease the lock-up in credit markets. The Discount Rate is the rate the Fed charges banks who borrow from the Fed Discount Window (as opposed to each other or the credit markets). Usually the Fed discourages Discount Window borrowing, but this time they orchestrated having several major U.S. banks (including Citigroup and Bank of America) borrow from the window to encourage other banks to use the window as a funding source. The Fed went so far as to accept as collateral illiquid mortgage securities which were being treated by other lenders as "toxic waste". This

rate move was followed by an additional reduction of 1/2 percentage point in both the Fed Funds and the Discount Rates at their regularly scheduled meeting on September 18th. The Fed Funds target now sits at 4.75% and the Discount Rate is 5.25%.

The Fed's activities have, so far, had the desired effect. Inter-bank lending has resumed and interest rates on lower-grade debt have begun to return to more normal levels.

Commodity markets and the U.S. dollar have not been so kind, however. We have written in past quarters about the need for central bankers worldwide to coordinate activities to stem speculation and address global inflation concerns. Prior to the mortgage meltdown, efforts to stabilize global inflation were working – gold had stabilized, oil was steady, even agricultural commodity prices seemed to be finding equilibrium. At the first hint that central bankers would pause from their tightening moves and lower interest rates, oil, gold and other commodity prices shot up. Simultaneously, the U.S. dollar fell to new lows against the Euro. Inflation jitters and the carry trade have returned. It was these bubble pockets that gave rise to the run up in real estate that led to the mortgage mess in the first place. The faster the transparency problems in the mortgage market get resolved so the Fed can resume its primary responsibility of fighting inflation the better. In the meantime, U.S. dollar weakness, rising commodity prices and strength in resource-based emerging markets are likely to continue.

For the foreseeable future, we think that concerns about the weakness in the banking system and the consumer sector are likely to drive Fed policy and the credit markets. As a result, we expect lower short-term interest rates; but with commodity inflation resuming and the U.S. dollar weakening, we expect that longer-term interest rates will rise and the yield curve will steepen. This should position many financial institutions to improve their profitability. (Most banks borrow money in the short-term markets and lend it to longer-term borrowers). As a result, once confidence in the balance sheets of financial institutions improves, they could perform quite well. The financial sector makes up almost 20% of the S&P 500, so a rally in these stocks could be a big driver of stock market performance in a year or two. In the meantime, weakness in the U.S. dollar is helping major exporters like United Technologies, GE and Boeing to be competitive by "goosing" their currency trading profits from overseas subsidiaries and helping drive sales of dollar-cheapened U.S.-sourced goods. The "blue-chip" Dow Jones Industrials are loaded with global enterprises, so their relative strength in the third quarter is likely to continue while the U.S. dollar remains weak. Coca-Cola, Merck, Procter & Gamble and Johnson & Johnson all derive a substantial portion of their profits from overseas and should benefit from the weak U.S. dollar.

Commentary

There are three fundamental principals underpinning the smooth functioning of modern financial markets: (1) liquidity; (2) transparency; and (3) data integrity. Over the summer, all three of these basic principals were called into question in the market for mortgage-backed securities.

Liquidity is important because if there are no buyers for a security, sellers can't transact and the pricing mechanism breaks down. For leveraged holders of securities, this can spell disaster. Without a price, the effective price collapses toward zero, lenders issue margin calls and leveraged asset holders are forced to post additional collateral. If there is no acceptable collateral to post, then liquid assets must be sold which can lead to a broad sell-off in financial markets.

Transparency is important because during periods of risk aversion, people need to be able to assess the risks they are taking so they can make wise decisions. If investors know that the assets underlying an investment are sound, they can hold through periods of market difficulty. But if investors don't know what they are holding, they are likely to panic and sell assets at distressed prices, further contributing to the meltdown. Also complicating matters is the role of leverage. As a lender, when it is unclear what your collateral is, you don't lend. But if you know you have good collateral, you can extend credit. Transparency facilitates capital flows between financial market participants and supports the markets.

Data integrity is important because when investors don't believe the data they are being presented, they won't invest without severely discounting the value of an investment, if at all.

This summer's turmoil in the mortgage markets was a result of all three of these fundamental principals breaking down. Lack of transparency in the mortgage market had become systemic because packages of mortgages had been sliced and diced into ill-defined "cash flows". Making matters worse, it appears that in the process of originating sub-prime and alt-A mortgages, fraud was prevalent, so the data underpinning the issuance and rating of mortgage securities was dubious. When buyers went on strike, liquidity left the market and the pricing mechanism failed. In the absence of pricing data, many mortgage instruments were valued at or near zero causing a flurry of margin calls and the collapse of leveraged market participants. Two noteworthy casualties were hedge funds run by Bear Stearns and UBS's Dillon Reed Capital. In both cases, the sponsoring organizations determined it was in their interest to cash out their investors and bring the assets in-house so as not to be forced to liquidate leveraged assets which were trading far below estimates of their deeply-discounted value.

In recent years, Wall Street has been actively promoting financial products that lack liquidity, transparency and the ability to verify data. Investors have piled into hedge funds, derivatives, structured products and emerging markets where transparency is lacking and data integrity is difficult to verify. And many of these investments have been made with borrowed money. We suspect that other financial panics are in the cards until investors once again adopt the position of "let the buyer beware".

We welcome your questions and comments.

SKY Investment Group LLC

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Stocks noted valued as of market close October 16, 2007:

Cisco Systems CSCO 32.29
Oracle ORCL 21.75
Citigroup C 44.79
Bank of America BAC 50.20
United Technologies UTX 79.65
General Electric GE 40.77
Boeing BA 95.94
Coca-Cola KO 57.76
Merck MRK 53.03
Procter & Gamble PG 70.82
Johnson & Johnson JNJ 65.07

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