



Quarterly Commentary: October 1, 2007

“A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.”

- Winston Churchill

The “C” words: CBO’s, CDO’s, CLO’s, CMO’s. These are a few of the acronyms that have dominated the financial headlines over the past several months during the course of the current “subprime fallout” that culminated in the extreme market volatility experienced in both the equity and fixed income markets during the month of August. That volatility, marked by an intraday decline of over 10% in the major stock indices on August 16th, was greeted soon thereafter by renewed optimism following what many on Wall Street consider to be the watershed event of the third quarter, when the Federal Reserve lowered the Federal Funds rate by 50 basis points at the September FOMC meeting. Most casual investors could not recite what the above acronyms stand for, let alone comprehend the complexities of the underlying financial instruments that have been the lightning rod for so much attention and scrutiny. Given some of the reported losses by global money center banks, investment banks, pension funds, hedge funds, and a myriad of other major financial institutions at the hands of these exotic financial instruments, it is evident that many professional investors failed to understand the complexities and risks of these instruments for themselves. We’re pleased to say that we do not count ourselves among them, as we would never be comfortable investing in exotic financial instruments that could potentially place our clients’ assets at risk of permanent loss of capital, regardless of the potential for higher returns.

While what we saw this quarter was unnerving to many to say the least, we couldn’t help but think that we were watching a movie that we had somehow seen before (and already knew how it ended). We don’t have to go too far back in recent history to find similar instances with which we can draw comparison and precedent: the Asian currency and Russian debt crises in 1997-1998, the collapse of Long Term Capital Management in 1998, and perhaps most important, the technology and dot.com bubble which “popped” in the Spring of 2000. Each instance was marked by significant volatility in financial markets and significant declines in asset prices, including stocks. Yet in each instance, market declines were subsequently followed by periods of significant positive returns – although the bursting of the tech bubble did cause a more extended decline in stocks through late 2002. Throughout these ups and downs, we remain steadfast in our investment approach with one objective in mind: produce consistent, long-term returns for clients in a disciplined and low risk manner. Each instance is unique, and the current one is no exception. As such, while it is impossible to predict the inevitable outcome, rest assured, we will continue to remain steadfast in our investment approach even now.

At a minimum, the recent market “meltdown,” as it has often been referred to in the media, has provided us all with another opportunity to revisit and reinforce age-old lessons of investing. First and foremost, it provides yet another uncomfortable illustration of market manias and crowd behavior, as we witnessed one bubble (*i.e.* technology stocks) give way to another (*i.e.* real estate). As stocks declined from 2000 until 2003, we observed capital flow into a multitude of asset classes that we refer to as “Anything But U.S. Equities” (ABUSE). While it’s difficult to quantify, what we believe transpired was a massive reallocation of assets from the stock market into alternative asset classes, such as commodities, real estate, and the aforementioned debt instruments that begin with the letter “C” – a trend that has continued to today.



When real estate replaced internet stocks as the favored topic of discussion at cocktail parties, we raised our eyebrows. When real estate-related articles touting the hottest real estate markets graced the covers of magazines like *Time* and *Newsweek*, we winced. When the ranks of residential real estate agents and mortgage brokers ballooned, we shook our heads. And when web sites like “condo-flipper.com” and real estate investors like Donald Trump took on pop culture-like status, we couldn’t help but feel a sense of déjà vu all over again. In certain ways, the real estate boom was driven by the same greed and excess which marked the dot.com boom, fueled by low interest rates and loose lending standards and facilitated by exotic debt instruments. Akin to the dot.com boom, we believe we are now witnessing a similar “popping” of the real estate bubble, but more in the form of a slow leak being felt across the housing sector of the economy, as opposed to a sudden burst. The harsh reality is that real estate prices could not go up forever and could not continue to rise faster than personal incomes – just as technology stocks could not continue their relentless climb without fundamental justification and without valuation support.

As recently as August, many hedge funds, employing what is commonly considered to be a low risk “market-neutral” strategy, took on enormous risk by investing in the above-mentioned exotic real estate-related debt instruments – even leveraging up their investments ten-fold or more in pursuit of higher returns. With all the capital flowing into these vehicles employing similar strategies, the trades became “crowded,” so to speak, and when the value of their assets declined during the recent market downturn, these funds were forced to reverse their trades and liquidate their positions. With too many people trying to rush simultaneously for the exits, this in turn only exacerbated the volatility that the market endured during the quarter.

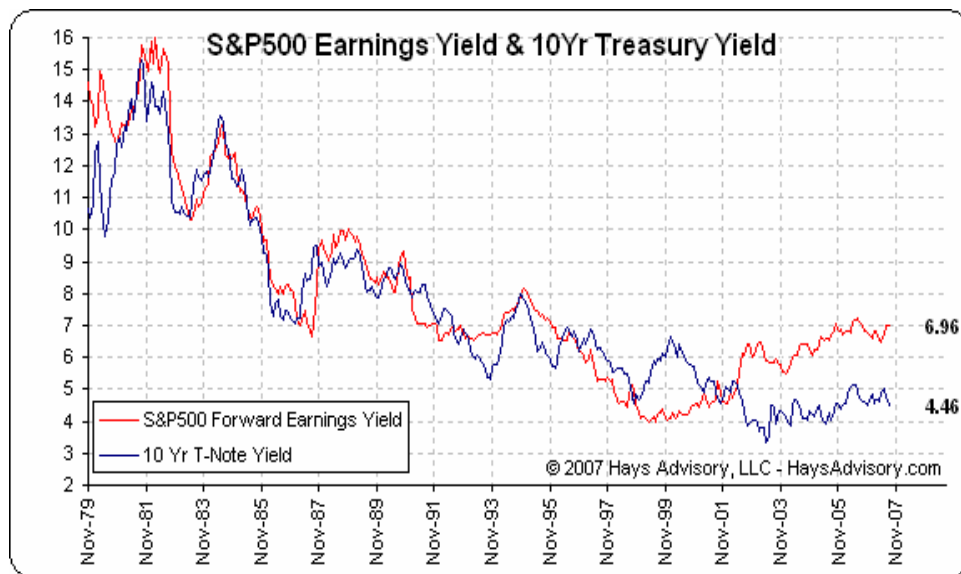
The silver lining to all of this is that market corrections provide a means of clearing out the excesses, thereby creating a dampening effect on unbridled speculation and resulting in a “cleansing effect” that ultimately proves healthy for the market over the long term. Importantly, as investors “flee” from riskier assets, they often turn to high quality stocks like the ones we own, seeking a safe haven. As we communicated to our clients in an email, on Wednesday, August 15th, the yield on the 90-day U.S. Treasury bill dropped nearly 10% to just around 4%. We pointed out then that this was a very rare drop, both in terms of its speed and its magnitude. It essentially indicated to us a “flight to safety” was taking place, as investors demanded more of the safest and most liquid forms of assets. We also noted that, since 1955, this kind of shift had only happened 22 times – in nearly 13,000 trading days, roughly a 0.2% occurrence – and that on average, when a shift like this one occurred, the stock market had rallied by an average of 22% during the following 12 months.

Yet an even more important reminder from this market turmoil is that uncertainty breeds opportunity. We are often asked by clients what we do during turbulent times such as these. First of all, we remain grounded and unemotional. Second, we continually assess and reassess risk in our investment portfolios. Finally, we may decide to buy, sell, or simply do nothing at all, depending on what we deem the most appropriate course of action to be at any given time. Most often, however, periods such as this tend to present enormous opportunities for sensible investors like us to identify “bargains” among the wreckage, considering that the market has a tendency to throw the baby out with the bath water (to borrow the cliché). While the typical investor is more apt to sell during periods of market turbulence and worry, we often view such volatility as an opportunity to buy attractive securities at attractive prices. Conversely, most investors also have a tendency to buy at market peaks and/or during periods of market euphoria, while we instead view such instances as opportunities to trim positions and sell into strength. After all, we are less concerned about market direction than we are about buying high quality, well-established, industry-leading companies that generate strong cash flow, are in sound financial condition, are competitively-positioned to benefit from global growth, and reward shareholders through dividends and



share buybacks. Regardless of short-term market direction, we think the stocks representing such companies will only continue to increase in value over the long term. With that in mind, we are currently researching potential opportunities in sectors that are extremely out of favor with Wall Street, whose performance has lagged tremendously during this quarter, and which remain under a dark cloud of concern given uncertainties regarding the overall economy and the current volatility in the capital markets.

For your benefit, we have included below a chart that we often share with clients. It shows the S&P 500 earnings yield vs. the yield on the 10-year Treasury note, and we consider it quite relevant to current market conditions. Note, in particular, the generally high correlation between the two, with the exception of the 1998-2001 time frame (which includes the tech bubble), a period during which the 10 year yield was considerably higher than S&P 500 earnings yield. Note also the time period from 2001 to present, in which the S&P 500 earnings yield has been/is considerably higher – owing to a combination of a) solid earnings and b) low interest rates. Given an earnings yield over 6% and a 10-year yield of roughly 4.6%, we believe the current market risk/reward is very favorable. Furthermore, we might add that at 17x trailing twelve months earnings (versus 24x for real estate and 21x for bonds) and at 15x forward earnings, the valuation of the S&P 500 is at its lowest level since 1995.



To conclude our remarks, we would like to leave you with a final quote to consider. This quote was made by Warren Buffett in response to a question by a financial news broadcast reporter on September 18th, the day the Federal Reserve lowered the Federal Funds rate by 50 basis points. We think it aptly sums up our views as well. He stated:

"The important thing in stocks is to buy a stock in a good business at a reasonable price. Anybody that is buying or selling stocks based on what the Fed is doing, or what they think they're going to do at their next meeting, I think is destined to not having a great financial future. It really doesn't have anything to do with the value of good companies 3, 5 years from now. People who think they can dance in and out based on Fed signals, I think, they're going to make their brokers rich, but they're not going to make themselves rich."



On a more personal note, we are delighted to announce that with the opening of our office in Pasadena and the addition of two more professionals in our San Mateo office, we now have 16 professionals to serve our clients. We look upon the opening of our Pasadena office as a momentous occasion for our firm and a tremendous opportunity for us to bring our high-caliber investment management experience and superb client service to that community. Our Pasadena office will be headed by Sherry Williams, Senior Relationship Manager, who brings over 17 years of experience in the financial services industry. We have known Sherry personally and professionally for over a decade and know that she embodies the same values we hold dear – that of fostering long-term relationships with clients through high quality investment management. Sherry, a graduate of University of California, Los Angeles, with a Bachelor of Science (BS) degree in Sociology, is a Certified Financial Planner (CFP®) and is a member of the CFA Institute, the CFA Society of Los Angeles, and the Financial Planning Association. She is joined in our Pasadena office by Corene Carlson and Diane Johnson, who have worked closely with Sherry for years at her previous firms, Bank of New York Mellon Corporation and the investment management firm of Van Deventer & Hoch. They will also assist with client service and support.

In San Mateo, we recently welcomed Eric Jungling, Operations Specialist, who brings over seven years of experience in the financial services industry, most recently serving in the Asset Management Division at Charles Schwab & Co. in San Francisco. Eric earned a Bachelor of Arts (BA) degree in Business Economics from the University of California, Santa Barbara. Eric will work with Joe Martin, Director of the Private Client Group and Jennifer Rouse, Operations Manager and Client Service Specialist, in administering client accounts and fulfilling client requests. Eric will also be pivotal to fostering our firm's ongoing relationship with Charles Schwab as our liaison to Schwab Institutional. Subsequent to Eric's arrival, we also added David Ogburn to our team as Principal, Business Development. Dave brings with him a wealth of capital markets knowledge and investment experience, given more than eleven years as an Institutional Equity Sales professional at leading Wall Street firms, such as Donaldson Lufkin Jenrette, Credit Suisse, and most recently, First Albany Capital, where he provided equity research and investment ideas to institutional investors. Dave is also a former U.S. Naval Officer, having earned the rank of Lieutenant, and is a veteran of Operation Desert Shield in 1990. Dave holds a Masters in Business Administration (MBA) from the Wharton School of Business, University of Pennsylvania, and an undergraduate degree in Humanities and International Affairs from Georgetown University. He will be primarily responsible for fostering new client relationships through the Schwab Advisor Network and will also be pursuing additional new business ventures for our firm.

Please join us in welcoming these five new members to the Golub Group family.

As always, we have included with this commentary your quarterly performance figures, management fee invoice(s), and a copy of your portfolio allocation as of 9/30/07. You are always welcome to visit us online and to access your account(s) at www.golubgroup.com. Please contact us to establish a login and password if you do not already have one. Finally, we are pleased to announce that Golub Group has added a toll-free number for your convenience. Feel free to call us at 866-60-Golub (604-6582) or to send us facsimiles at 866-68-Golub (684-6582).

Our best regards,

The Golub Group

Disclaimer: All opinions presented in this commentary are strictly those of the Golub Group. You should not construe any implied or expressed conclusions presented as a promise of future returns.

2929 Campus Drive, Suite 145, San Mateo, CA 94403 • Phone: (650) 212-2240 • Fax: (650) 212-2249
215 North Marengo Avenue, Suite 380-G, Pasadena, CA 91101 • Phone: (626) 356-2400 • Fax: (626) 356-2415