



Quarterly Commentary: January 4, 2008

The warmth of the holiday season lingers for many of us, but it seems a few grinchers – fear and uncertainty – gained the upper hand this past quarter. The immediacy of the fourth quarter’s market swoon may make it easy to forget that the broad market indices turned in a year of positive performance: including dividends, the Dow Jones Industrial Average gained 8.9%, the NASDAQ Composite gained 10.6%, and the S&P 500 gained 5.5%. We are generally pleased with the performance of your managed portfolios and believe they remain well-positioned for the future.

A year like 2007, and those grinchers of the fourth quarter, remind us why it is important to have a team of investment professionals managing your assets. First, fear and uncertainty are emotions best removed from the investment process. Indeed, it is wise to identify situations full of fear and uncertainty, since that’s when great long-term opportunities arise. Second, this was a year where quality mattered – quality businesses run by quality management teams. We saw how so many thoughtless corporate management teams destroyed shareholder value as the mortgage-related credit bubble expanded and then began to deflate in earnest during the second half of the year. At the Golub Group, we have always focused on finding quality, and finding it on the cheap.

The fallout from the deflating credit bubble may persist for quite some time, and we’ve already seen the initial impact as some of those aforementioned management teams were shown their exit. Yet it was what came next (and quite recently) that strikes us as among the most memorable moments of 2007. A few of the country’s largest financial institutions have turned, hat in hand, to various Asian investors to shore up their financial positions. Citigroup sold up to a 5% stake in itself to the Abu Dhabi Investment Authority for \$7.5 billion, Morgan Stanley sold up to a 10% stake in itself to the China Investment Corporation for \$5 billion, and Merrill Lynch sold up to 10% stake in itself to Singapore’s Temasek Holdings for \$5 billion. Clearly, these are not minor investments.

Welcome to the era of the sovereign wealth fund. All three companies highlighted the long-term focus of these passive investors, and that is of course significant. But to us, there is a broader and more compelling signal in these deals. The fear grinchers will see venerable U.S. corporations selling out to foreign governments – some of which, by gosh, were recently controlled by communists! We see it, however, as the latest incarnation of globalization, where the United States has plenty of company in the creation of great wealth. Asian and Middle Eastern economies are creating wealth at a remarkable clip, and global markets are now structured to allow that capital to flow to the places which hold the most value, or promise the best returns. Right now, the U.S stock market tops that list.

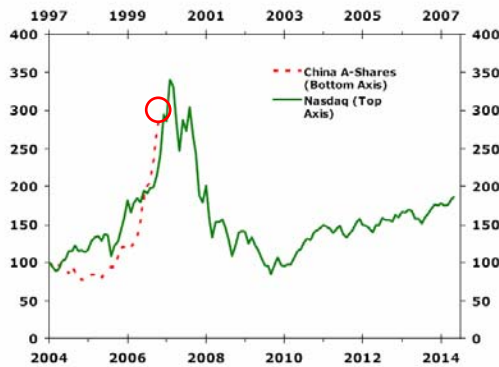
Given all this emerging markets wealth, it might seem logical to invest directly at its source – that is, in the stocks of emerging markets companies. The power of that logic has proven quite tempting for many investors, who now seem willing to overlook valuations and fundamentals in search of outsized returns. Sound familiar? It should, since the same factors were at work during the recent technology and real estate bubbles. Emerging markets investing strikes us as the latest blind faith investment fad, and one that is shaping up to be the next bubble.

Of growing note to us is the tremendous amount of capital flowing into various emerging markets around the globe, pushing up valuations of assets in those markets. For example, Morningstar reports that 2002 saw the establishment of just one new emerging markets fund; this year, there have been 16. In the second quarter of this year alone, domestic mutual funds reported net outflows of \$8.5 billion



while non-domestic funds reported net inflows of \$30.75 billion, according to AMG Data Services, which tracks such fund flows. While we recognize the extraordinary growth taking place in, for example, the “BRIC” countries (Brazil, Russia, India, and China), we wonder to what extent this growth has been more than adequately reflected in financial market performance. For example, the Shanghai Stock Exchange A-Share Index appreciated over 100% this past year. While it is nearly impossible to predict market tops, we include the following chart as food for thought, specifically noting the location of the “you are here” circle.

CHINESE A SHARES AND THE NASDAQ – AN UNCANNY RESEMBLANCE



Sources: Strategas Research Partners & Catalpa Capital

This chart gives us an initial look at what might be on the horizon in the Chinese market, and indices in several other emerging markets look similar. Digging deeper, however, we see a more fundamental cause for concern. The forward Price-to-Earnings (P/E) multiples on the Chinese and Indian markets, at roughly 24x and 22x earnings, respectively, are nearly *double* their long-term averages, while the 15x P/E on the U.S. market represents nearly a 20% discount to its long-term average. Viewed another way, government bonds issued by several emerging markets countries (including China, India, Brazil and Indonesia) are offering yields *above* the earnings yields of those countries’ stock markets, suggesting that investors believe those countries’ stocks are now less risky than their sovereign debt! Here in the U.S., we see the opposite and far more rational situation: our stock market is trading at an earnings yield of about 6% while the yield on the 10-year Treasury hovers around 4%. This is a very favorable valuation scenario.

We are not suggesting that these statistics will preclude us from investing internationally. Rather, we will continue to pursue our same prudent approach when investing in international markets as we do when investing domestically. That means that we will not invest in international markets solely for the sake of maintaining “exposure,” and we won’t simply allocate funds to certain emerging markets in a benign fashion without regard to fundamentals, risk, and valuations. We will continue to focus on the same business characteristics (*e.g.*, industry-leading position, sound financial condition, proven management teams, strong operating performance), and analyze the same measures of value whether a company is U.S.-domiciled with growing international revenues, such as Coca-Cola, Cisco, or Anheuser-Busch, or foreign-domiciled, such as Canadian Oil Sands, China Mobile, or Diageo.



So as capital flows from Asian sovereign wealth funds to financial services companies in the United States, it also flows from (largely) retail investors to the emerging markets across the globe. What's the difference between these two trends? First, the structure of the investments: the sovereign wealth fund deals are long-term in nature, while mutual fund investors can back out (*i.e.*, sell) at any time. Second, fundamentals: despite recent missteps, the financial services companies maintain powerful brands, robust systems and impressive human capital. Meanwhile, many emerging markets companies could be wiped out by tighter credit conditions or increased inflation – both of which are historical hallmarks of emerging markets – to say nothing of their own, often precarious competitive positions in the global market. Third, and by far most important, is valuation. As we've discussed, the prices paid for many emerging markets stocks borders on the ridiculous. By comparison, domestic valuations are the ultimate shock absorber; many large-cap, blue-chip companies can take a pretty decent hit to their earnings before valuations look unreasonable. Simply put, the United States is right now the world's best bargain.

In closing, we'd like to offer some evidence that is admittedly anecdotal but perhaps just as compelling as what we've written above. *Time* magazine just placed Russian President (and soon, Prime Minister) Vladimir Putin on the cover as its 2007 Person of the Year. Among other topics, the accompanying article discusses Putin's role in driving economic growth in his country. But by their very nature, magazine covers capture the zeitgeist. As such, they reflect what is broadly discussed and roundly seen – or in our parlance, what is likely already discounted by the market. To wit, Amazon.com CEO Jeff Bezos was named *Time* Person of the Year in 1999, just months before the peak of the NASDAQ. More recently, *Time* ran a cover depicting a cartoonishly happy man hugging his house under the headline, "Home \$weet Home: Why we're going gaga for real estate" (please note the dollar sign). That cover ran in June 2005, roughly one year prior to the top in residential real estate prices (as measured by the S&P/Case-Shiller Home Price Index). So if Jeff Bezos reflected the nearing top of the internet bubble, and the home hugger signaled a coming peak in residential real estate, perhaps Vladimir Putin is emblematic of a coming top in emerging markets investing. Time will tell – but history doesn't often disappoint.

As the new year unfolds, we thank you for your trust and your support. We have included with this commentary your quarterly performance figures, management fee invoices, and a copy of your portfolio allocation as of 12/31/07. Please also be advised that for those of you with taxable accounts managed by us, we have enclosed your 2007 Realized Gains & Losses report for those accounts. These reports should be given to your accountant, along with the IRS Form 1099 that you will be receiving from Schwab in early February. Note that if there is a "0" in the cost basis column, it is because we did not have the cost basis information for these securities. If you have this cost basis information and would like us to update the report, please give us a call and we will update and resend it to you. As always, you are welcome to visit us online and to access your accounts at www.golubgroup.com. Please contact us to establish a login and password if you do not already have one. We wish you and yours peace and prosperity in the coming year.

With warm regards,

The Golub Group

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