Ponderosa Investment Group LLC
INVESTMENT LETTER

Third Quarter 2007 • V6

The subprime-fueled liquidity crunch in the third quarter cascaded into broader risk avoidance by investors, hedge funds, and other financial market players. With the Fed's rate cut, things have settled down but they have not returned to normal.

The other major problem is the housing market, where excess supply, declining prices, and tighter credit are feeding each other. With the housing ATM out of cash, the economy is faced with the possibility of a material slowdown in consumer spending—a key driver of economic growth.

It is difficult to predict with confidence how the economy will play out, but I can measure valuations with greater confidence. Stocks appear to be in a fair-value range, but with the possibility of recession increasing and earnings growth likely to decline from historically high levels, I believe it is time to reduce the equity overweight back to neutral weight. I don't think it makes sense to be overweighted to stocks currently.

The Investment Letter is mailed quarterly to my clients and friends to share some of my more interesting views.

Quarterly Investment Commentary

The market volatility, credit crunch, housing market collapse, and hedge fund debacles make it hard to believe the overall stock market was in the black during the third quarter. But it was, with the S&P 500 gaining 2%. Moreover, through September the index is up 9.1% on the year. While the broad market managed nice gains, there was a wide degree of variation across asset classes. Value benchmarks were in the red for the quarter, with smaller-caps doing worst. Growth benchmarks did quite a bit better, with larger-cap growth stocks generally delivering strong returns during the quarter. For the year growth is ahead of value by a wide margin after seven consecutive years of underperformance. International stocks gained over 2% in the quarter, extending their run of impressive returns. With the exception of high-yield bonds, most other fixed-income asset classes had a solid quarter, with investment-grade bonds climbing almost 3%. Commodity futures gained over 6%. REITs managed to post a positive quarter with a return of approximately 2.0%, though they are still in the red on the year.

2007 Index Performance	3rd Qtr.	YTD
Citigroup 3 Month T-bill Index	1.19%	3.71%
Lehman US Aggregate Bond Index	2.84%	3.85%
M.L. US High Yield Master II Index	0.33%	3.40%
S&P 500 Index	2.03%	9.13%
Russell 2000 Index	-3.09%	3.16%
MSCI EAFE N$ Index	2.18%	13.15%

"Prediction is Very Difficult, Especially of the Future"

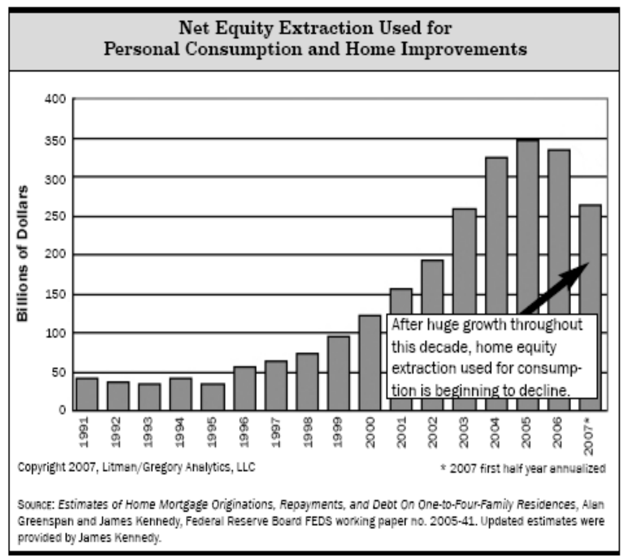
The above quote, credited to physicist Neils Bohr, comes to mind in assessing the developments of the turbulent third quarter and what they may mean for investors.

The Economy—It is easy to find plenty of intelligent-sounding predictions about the economy. Investors are drawn to such forecasts because they make investment decisions much easier. Unfortunately, accurately predicting the future is another story. The real key is to accept that some things are inherently uncertain and instead focus on the knowable. The trick is then to balance the two in assessing a range of possible outcomes

When it comes to assessing possible scenarios, it would be immensely helpful to accurately predict the health of the economy. One thing I know is that credit is the lifeblood of the economy and it has become less available than it was just months ago. The ease with which homebuyers could access capital will go down as one of the defining characteristics of these last few years, as it contributed to an unprecedented surge in housing prices in many parts of the country. At the same time, in the leveraged buyout market, loans were written on remarkably generous terms, which spurred acquisitions at ever increasing cash-flow multiples and boosted stock prices.

Unfortunately, when excesses end, things don't just return to "normal." Often they go to excess in the opposite direction. This type of snapback triggered much of the volatility during the third quarter as there was an extreme lack of interest in holding consumer-backed debt, and an inclination on the part of most institutions not to lend to each other. This cascaded into broader risk avoidance on the part of investors, hedge funds, and other financial market players who had played an important role in expanding the amount of available credit. This was greatly exacerbated by large amounts of leverage (debt) held by many of the non-bank credit providers (e.g., hedge funds). The result was that credit, which as noted is crucial to the economy, was sharply restricted for a few weeks. With the Fed's decisive action in September to cut the federal funds rate by 50 basis points things have settled down, but they have not returned to normal. Capital will no longer be available to certain groups of borrowers, at least for a couple years, and it will be costlier to other groups. This we can count on and it's not a bad thing, because excess liquidity was leading many investors to make imprudent investment decisions. What is bad is a seizing up of the credit markets in a credit-dependent economy. It seems highly probable that the economy will, at the very least, experience slower growth.

The question now is how long it will take to fully return to a normal credit environment, which is necessary to mitigate recession risk. If there are other events that shock the markets and cause another retrenching, recession risk will rise further.



With the housing ATM machine largely shut down and home sales severely slumping, the economy is faced with the possibility of a material cutback in consumer spending—the primary driver of economic growth. Consumers have less cash available, there are fewer homebuyers buying things for their new home, and the homebuilding and mortgage industries are retrenching. All this has a negative multiplier effect on the economy. A key going forward will be the labor market, which, while still pretty healthy, has begun to exhibit a few signs of weakness over the past few months, starting even before the summer meltdown. The problems seem bleak, but as always there are additional factors to consider.

The global economy has been quite strong and is less dependent on the U.S. than it used to be. For example, according to Goldman Sachs, the four largest emerging market economies—Brazil, Russia, India, and China—are responsible for a sizable portion of the growth in global demand and significantly more than the U.S. In general, due to much-improved economic fundamentals, the emerging markets are playing a much more important role in the global economy. On the other hand, the credit crunch is being felt around the world, not just in the U.S. Europe, in particular, is sharing the U.S.'s experience and in several countries there are similar problems in the housing market.

The weakness in the dollar, as long as it doesn't turn into a rout, is like an interest rate cut. It will help U.S. export growth, which has already been very healthy, and contribute to the bottom line of U.S. firms that do business globally. Meanwhile, a dollar collapse is unlikely because this outcome would be very harmful to the global economy. For this reason central banks around the world would take extreme measures to avoid it.

The Fed does have influence and room to maneuver. If the economy continues to weaken, the Fed can be expected to continue to lower short-term interest rates to make more capital available at a lower cost, which should spur the economy. But the financial markets are expecting additional rate cuts, so if the Fed doesn't keep lower rates this year, market participants are likely to react negatively. Also, additional Fed rate cuts (along with a declining dollar) may spur increasing inflation expectations, which would not be a positive for the economy or longer-duration interest rates.

The bottom line is that the economic outlook is murky. Due to the credit crunch and continued deterioration in the housing market, recession is more likely than it was earlier in the year. But it is not a foregone conclusion. The few firms whose economic forecasting I respect (which doesn't mean they are always right or that I make decisions based on their forecasts) continue to believe that a recession is not the most likely outcome, but most are less confident than they were a few months ago.

What This All Means—As I frequently note, decisions are constantly being made in an uncertain world. Economic predictions are not accurate enough to serve as a basis for investment decisions. I'm more confident in valuation work as a basis for decisions, but this can not be done in a vacuum.

Looking at the current environment, we know the economy could fall into recession. But it could also avoid recession and surprise on the upside with the aid of Fed easing, a weaker dollar that stimulates exports, and global growth driven by emerging markets. Getting defensive in the portfolio allocations could result in missing out on returns that could be captured during, potentially, a few more years of economic growth. (It's worth noting that many of the "experts" arguing for a defensive posture now have been bearish on equities for many years and missed the very strong global equity market rebound since 2003.) On the other hand stocks could drop 10% to 20% in a cyclical bear market.

So what do we do? In setting client's portfolio allocations, first I draw upon the basic building blocks of diversification. This includes using investment-grade bonds, and more recently adding the absolute\alternative asset class, to protect against recession. The historical, common-sense framework helps me understand how asset classes perform in a variety of environments, including cyclical bear markets. Moreover, that framework allows me to understand the factors—liquidity, interest rates, starting valuations, and earnings, for example—that drive the performance of each asset class from one cycle to another. Not every cycle is the same.

Second, I factor in the valuation analysis for each asset class. Currently, I believe the major asset classes are in a neutral territory—meaning they are neither very attractive nor very unattractive on a long-term valuation basis, and I therefore see no reason to currently over- or under-weight any of them.

Third, I consider the maximum loss thresholds, which allow me to accept a certain amount of near-term risk (less than one year) in exchange for some flexibility to capture long-term return (three years or more). I "stress test" each portfolio strategy against different possible scenarios so that I can assess the amount of downside one-year risk I think each portfolio would be exposed to. If this scenario analysis suggests that I'm taking on too much short-term risk relative to the potential long-term return benefit, I will adjust the portfolio allocation accordingly.

This disciplined approach allows me to capture long-term returns that are driven by factors in which I have higher confidence (valuations), while still keeping risk in line with each portfolio's profile. Today, this process leads me to consider reducing the portfolio equity allocations back to a neutral position. For some time I've believed most equity asset classes to be in a "fairly" priced range—suggesting that over the long run that equities would outperform more defensive asset classes (e.g., bonds). The portfolios have been rewarded for taking this view. But I have also recognized that, as always, there are troubling risks. Equity-type asset classes are not currently priced at levels that are low enough to ignore these risks and entice me to maintain the equity overweight that has been in place for sometime now. I also have been concerned about the likelihood that corporate earnings growth will slow from its historically high recent levels. So I have decided to reduce portfolios' equity weights back to a neutral weight, thus reducing the portfolios' overall risk exposure.

Final Thoughts

With three-quarters of the year in the books, returns have been decent, though I admit it doesn't feel that way given the turbulent summer and high level of uncertainty. So far this year my asset allocation plays has added value in 2007, with large-caps (I'm overweighted versus small-caps) outperforming small caps and equities outperforming bonds.

As always, I will continue to challenge the assumptions that underlie my view, consider new information as it becomes available, and stay intellectually honest in making well-reasoned investment decisions for my clients. I appreciate your confidence and trust.

Best Regards,

Jim Cheadle
Ponderosa Investment Group, LLC

Contact Information

4888 NW Bethany Blvd. Suite K5, #154
Portland, OR 97229

Phone # (503) 286-0005
Fax# (503) 286-1050
Cell # (971) 227-0097
E-mail jcheadle@ponderosaig.com

Footnote Disclosure

This newsletter is limited to the dissemination of general information pertaining to Ponderosa Investment Group, LLC. Past performance is no indication or guarantee of future results. The data and information in these materials is provided for informational purposes only and should not be used or construed as a recommendation or solicitation to buy or sell any security or fund. All data provided by Ponderosa Investment Group, LLC is based solely upon research and information provided by third parties. Index performance or any index related data is given for illustrative purposes only and is not indicative of the performance of any portfolio. Note that an investment cannot be made directly in an index. Individual client needs, asset allocations, and investment strategies differ based on a variety of factors. Any reference to market indices is included for illustrative purposes only, as an index is not a security in which an investment can be made. Index returns shown are total returns which include both security price movement and reinvested dividends. Index returns shown over a 12-month period are annualized. Citigroup 3-Month Treasury Bill Index is an unmanaged index representing monthly return equivalents of the yield averages of the last 3 month U.S. Treasury Bill issues. Barclays U.S. Aggregate Bond Index is a broad-based bond benchmark that represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for the government and corporate securities, mortgage pass-through securities, and asset-backed securities. This is an unmanaged bond index and it is not possible to invest directly into. BofA Merrill Lynch U.S. High Yield Master II Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule and a minimum amount outstanding of USD 100 million. Bonds must be rated below investment grade based on a composite of Moody's and S&P. S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the large –cap segment of the U.S. equities market. Russell 2000 Index is an unmanaged group of stocks considered to be a representative of the small-cap segment of the U.S. equity universe. MSCI EAFE Index is an unmanaged equity index which captures large and mid-cap representation across Developed Markets countries in Europe, Australia, and the Far East represented in U.S. Dollars. It is a market-capitalization weighted index of 21 non-US, industrialized countries. Dow Jones –UBS Commodity Index is an unmanaged broadly diversified index that allows investors to track commodity futures through a single measure. It is composed of future contracts on physical commodities. The index is designed to minimize concentration in any one commodity or sector. It currently has 19 commodity futures in seven sectors.