

TO: CLIENTS & FRIENDS
FROM: TWIN FOCUS CAPITAL PARTNERS, LLC
RE: QUARTERLY COMMENTARY – APRIL 2007

“There is a very important difference between being a theoretical contrarian and dealing with it in practical terms. “

- Michael Steinhardt

- During the first part of the quarter markets touched new highs and exuberance continued; until of course, when investors woke up during the last week of February and gains quickly evaporated as risk was “re-priced”.
- The quarter’s headlines were dominated by record earnings; Private Equity – deal after deal, each one topping the prior; the unwinding of the Yen carry-trade, and most recently, the subprime debacle.
- Despite the bullish defense which set in at the end of February, we have a tough time convincing ourselves that the lows have yet been seen, especially after experiencing eight straight months of a near-20% exponential move from the July bottom.
- The Mortgage Bankers Association indicates that the overall system is showing signs of stress. In the last quarter of 2006, the percentage of mortgages entering the foreclosure process hit a record high.
- We believe that problems in subprime are not self-contained, and furthermore that housing has a ways to go before bottoming. The fear is that the mess in housing will get out of control and lead to a more dramatic slowdown or even recession.
- The actual value of the yen-carry trade is unknown in dollar terms and has gone on so long that the BOJ does not have data on the currency floating. The yen’s volatility and misalignment in terms of real currency value is distorting the world economy. The unwinding could negatively affect any asset that must be sold in order to pay down the trade.
- Since 2001, at the tail end of our last recession, corporate profits in the United States have enjoyed consistent quarter-over-quarter double digit growth. They currently stand at 12% of GDP, 33% above their historic average of 9%. Cash-rich balance sheets, however, as well as hefty free cash flows have made public companies the perfect targets of Private Equity firms in an environment of low interest rates.
- We are positioning portfolios defensively, however maintaining a moderate exposure to Global Equities, should they continue to rally on positive economic news. We believe that the US dollar will continue to weaken relative to other major currencies, and that the Fed will have to lower interest rates due to further mortgage woes, which could put further pressure on the dollar relative to other major currencies.

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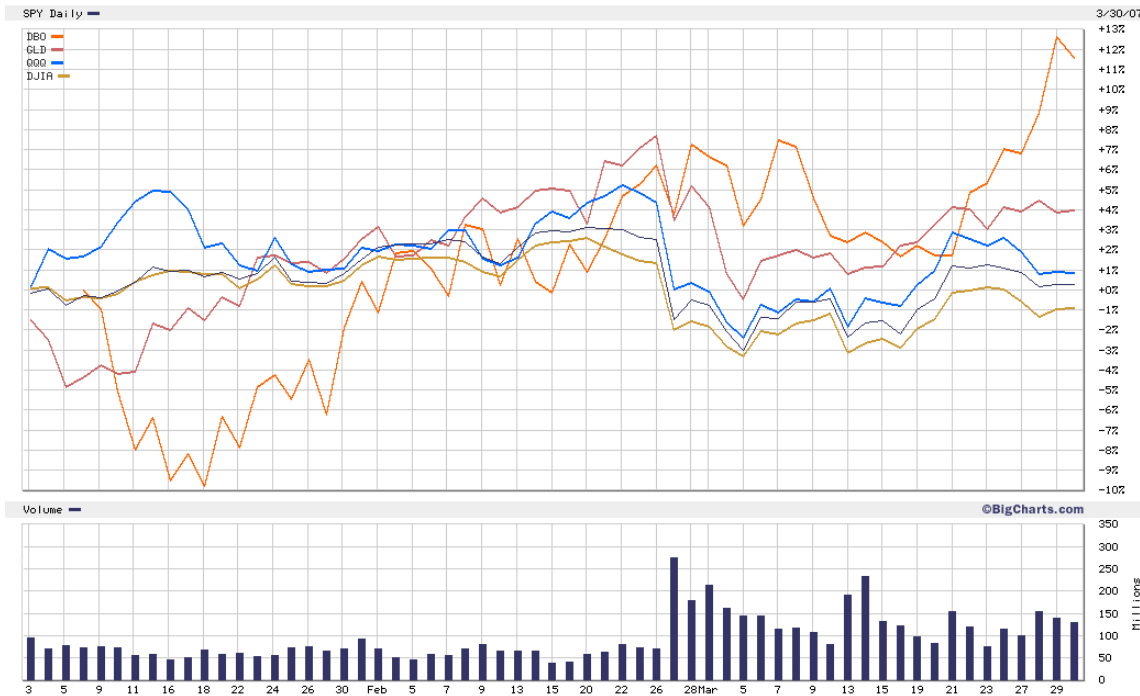
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The year in the global equity markets began much like it left off in 2006 – on fire. Markets touched new highs and exuberance continued; until of course, when investors woke up during the last week of February and gains quickly evaporated as risk was “re-priced”. Year to date, all major market indices were about flat with the S&P 500, Dow Jones and Nasdaq at +0.18%, -0.87% and +0.26% on a price basis, respectively. More volatile Emerging Markets are up by 1.79% after being down by over 3% at one point, while most major bond indices were positive with the Lehman Aggregate by +1.5% and the Lehman Global Bond by +1.07%. Gold has held on to its gains, up 4.37% while oil was marginally positive by 2.37% after rebounding for a double digit tumble during early January’s mild weather conditions. While oil has spiked recently on the backs of geopolitical headlines in Iran, we could see prices soften should we see a more dramatic US-led economic slowdown. The quarter’s headlines were dominated by record earnings; Private Equity – deal after deal, each one topping the prior; the unwinding of the Yen carry-trade, and most recently, the Subprime debacle.



Despite the bullish defense which set in at the end of February, we have a tough time convincing ourselves that the lows have yet been seen, especially after experiencing eight straight months of a near-20% exponential move from the July bottom. Furthermore, we’ll point out that even with the most recent air pocket, this is the second longest stretch in history where the markets have gone without a 10% correction. Since the end of February, the market has partially rebounded, and most recently after the Fed policy meeting where the Committee left rates unchanged and signaled softer policy. The market read this as rate cuts to come. We find this a bit ironic given the already massive amount of liquidity in the system, however we do believe that we could see aggressive rate cuts by

the Federal Reserve in response to a housing led downturn in the economy and subsequent negative effects on the consumer, although fears of inflation may hinder that in the near term.

China has been a case in point where cheap money driving the underlying economy stokes rampant speculation in the stock market. While demand from consumption is still in place, the government has been attempting to slow growth by tightening monetary policy. So far, it seems to be working – evidenced by the reduction in fixed asset investment. The challenge is always to rebalance growth without subjecting the economy to a downturn lead by excessive monetary tightening.

Sinking Sub-prime...

There has been much discussion in the past few weeks about the Sub-prime Lending market. “Sub-prime” mortgages are essentially loans made to low credit quality borrowers and typically offered at rates 2-3% higher than more conventional loans due to the inherently higher risk. More optimistic observers point to the fact that the subprime market is only a small fraction of the loans outstanding, and although this may be true, recent data out of the Mortgage Bankers Association indicate that the overall system is showing signs of stress. In the last quarter of 2006, the percentage of mortgages entering the foreclosure process hit a record high. Mortgage debt as a percentage of household income is now at the highest level since data was first collected in the early 1980’s.¹

Time Runs Like a Fuse and the Sub-Prime Fuse is Burning

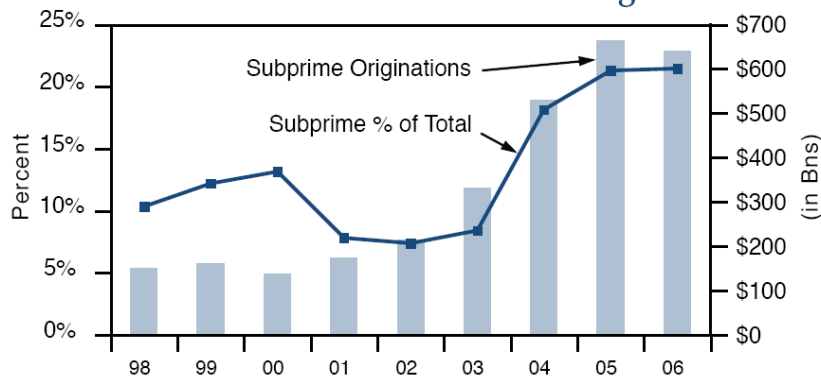


Chart 2

Source: Inside B&C Lending

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Total Sub-prime lending increased in the United States from 6% of total mortgage lending in 2002 to over 20% of the volume in 2006. Not only has the mortgage industry lowered underwriting standards but also created exotic new products with interest-only features and low teaser rates, also known as hybrid mortgages. These hybrid mortgages initially make them more attractive to potential borrowers but potentially much riskier, especially as interest rates begin to climb as they have. Approximately three quarters of the Sub-prime mortgages underwritten in 2004 and 2005 were of the hybrid type with an adjustable rate feature that will reset beginning this year. It is estimated that over \$600 billion of mortgages will reset in 2007, with subprime accounting for over half. Long-time readers may recall our outcry over Alan Greenspan’s push for Joe Public to take out adjustable rate mortgages back when Fed Funds rates were hovering around 1%. Now we are beginning to see the day of reckoning. We believe that problems in subprime are not self-contained, and furthermore that housing has a ways to go before bottoming. The fear is that the mess in housing will get out of control and lead to a more dramatic slowdown or even recession. Only time will tell.

¹ Shakedown, The Economist, March 14th, 2007

² Global Central Bank Focus: The Plankton Theory Meets Minsky, Paul McCulley, PIMCO, March 2007

When your earnest authors were explaining the nature of these loans in a recent conversation, one participant chimed in, saying, “well of course they are defaulting, and who would have thought otherwise?” We tend to agree, however, that when times are good and credit standards are loose, the subprime business is very lucrative. It’s easy to obtain loans with exotic features that may make it attractive to borrow under current conditions... the problem is what happens when conditions change. Some home buyers borrowed with hopes of getting in on the party of easy profits (or so it seemed), selling not too far in the distant future and so escaping the perils of default. As they say in finance, ‘there’s no free lunch, my friend’. Stress on this segment of the buyers in the food chain will have ripple effects throughout the entire system, and we expect demand for new and existing homes to decrease. The volume of data seems to indicate that the subprime buyers have increasingly been the marginal buyers of housing, increasing the demand and ultimately driving prices into the stratosphere. Additionally, employment rates could get hit as job losses increase in the construction, mortgage finance and real estate brokerage sectors. The day traders turned real estate “executives” may soon be searching for yet another career.

The daily headlines have been plastered with mounting defaults and troubled national lenders such as New Century, its sources of funding drying up. Lenders further up the food chain have put the squash on credit lines and other forms of financing, and many are even demanding accelerated repayment of outstanding loans. The stocks of these erstwhile Wall Street darlings have been getting hammered, with some even facing delisting by the Exchanges. Perhaps the most alarming fact, however, is that the mortgage credit problems go well beyond the sub-prime market. In fact, delinquencies on Prime adjustable-rate mortgages are rising much more quickly than sub-prime fixed rate loans. The credit quality of Prime adjustable rate lending with low initial teaser rates is deteriorating at a pace similar to that of sub-prime loans. We believe that the next big problem within the mortgage industry, perhaps bigger than the sub-prime problem, could be the “Teaser Rate” problem where borrowers have to refinance at higher rates. This could be one of the significant catalysts that will force the Federal Reserve to lower interest rates in the not so distant future.

The low interest rate environment over the last several years, coupled with new and exotic products from our mortgage industry and easy and aggressive credit practices to new and existing homeowners, has propelled housing prices to levels not seen in US history. This in turn created a feeling of wealth for new and existing homeowners, allowing them essentially to use – avoid split infinitive their homes as “checkbooks” and “ATM” machines for consumption purposes. However, as sub-prime and prime lenders begin to default and as over one trillion dollars of mortgages come due over the next 12 months and monthly mortgage payments are reset much higher from current levels, consumers will find they have less disposable income to consume, which will ultimately translate into slower GDP growth and a slower economy. On a positive note, one third of all homes in the United States are owned outright and 57% have traditional mortgages, leaving a much smaller pool of homes that are potentially exposed to either sub-prime or teaser rate issues. With consumer spending representing 70% of GDP, by how much will we feel these issues? As the ever-prescient Mr. Shakespeare put it in *Hamlet*, “Aye, there’s the rub.”

Carrying Yen, Anyone?

In a recent conversation with a friend based in Asia, it was pointed out that the largest investor in the yen-carry trade is the nation of Japan itself, which includes Japanese nationals selling yen in search of higher yields in foreign denominated bonds such as US Treasuries (rates in the US are at 5 ¼ %, 3 ½ % in Europe and ½ % in Japan). Central banks in Japan and China are doing this in efforts to support the US dollar and consequently depressing their own currencies while enabling US consumers to keep importing. The Japanese Government currently holds over \$900 billion of foreign exchange reserves. Emerging-market countries have built huge war chests of foreign reserves in case they ever need to fight another currency war such as in 1997.

The actual value of the yen-carry trade is unknown in dollar terms and has gone on so long that the BOJ does not have data on the currency floating. By one measure it has been estimated to be over a trillion dollars, based on the amount of yen trading on the Chicago Mercantile Exchange, where it

is being exploited in portfolios amongst hedge funds, money managers and insurance companies globally. The yen's volatility and misalignment in terms of real currency value is distorting the world economy. Because Japan is a major economic and trading power, the value of the yen plays a critical role in determining the pricing of its products and ultimately the balance of trade. Most importantly, financial turmoil and global instability are associated with periods when the Carry Trades unwind, such as the period following 1998 after Russia's default in August and the subsequent near collapse of Long Term Capital which sent the yen surging 13% in three days followed by volatility in global equity markets.

As speculators borrow yen at low rates in order to buy another foreign currency where returns are higher, the effect is to lower further the yen exchange rate relative to other major currencies. Many observers think that this trade has buoyed the price not only of US Treasuries but of virtually all risk assets globally. This strategy works only if speculators believe that the yen will remain weak or undervalued when they reverse the trade. Any appreciation will increase the repayment cost when they have to reverse the trade to sell the dollar and buy back the yen, which will offset the interest rate differential. The appreciating Japanese yen crimps global liquidity and pressures carry-trade participants (speculators) to sell risk assets and repay loans. One sign that this is already occurring is the tight correlation between global stock and corporate bond prices, and the dollar against the yen. Most recently, on February 21st, the Bank of Japan raised rates from 25 bps to 50 bps, followed by a global sell-off.

One of our thoughtful managers believes that this global liquidity is an overall negative for US markets and describes it as "evidence of the existing claims of other nations against our future prosperity".³ Current market participants watch the value of the yen very closely to see how this current carry trade is being played out. Any sort of good news about the Japanese economy and at the same time news that the US economy appears to be stalling could begin the process of "unwinding" the carry trade. The lesson of 1998 is that it takes only a small piece of news to trigger the domino effect. This unwinding could have a negative effect on any assets that must be sold in order to pay down the trade. Some are calling the link between the fallout in the subprime market and yen carry trade a contagion. If the troubles in the subprime market deepen and the yen strengthens further, traders could be forced to further unwind other trades in risk assets.

Private Equity in the Public Eye

With so much in the headlines about Private Equity, this commentary would not be complete without at least a mention. As our clients know, we are strong believers in the benefits of this asset class. Oftentimes, PE firms invest in companies listed on public exchanges, and then take them private. What distinguishes this asset class from the traditional equity asset class are the vast quantities of leverage they use to buy their targets. The recent low interest-rate environment as well as cash-rich corporate balance sheets and healthy free cash flows have been the catalysts driving this most recent mania. Keep in mind that although PE is so much in vogue, it is not new. It was referred to as "bootstraps" in the 1970's, "leveraged buyouts" in 80's and turned into "private equity" in the 90's. With so many large PE firms expected to go public, The Carlyle Group's founder David Rubenstein has been promoting the concept of a new name: "change equity."⁴

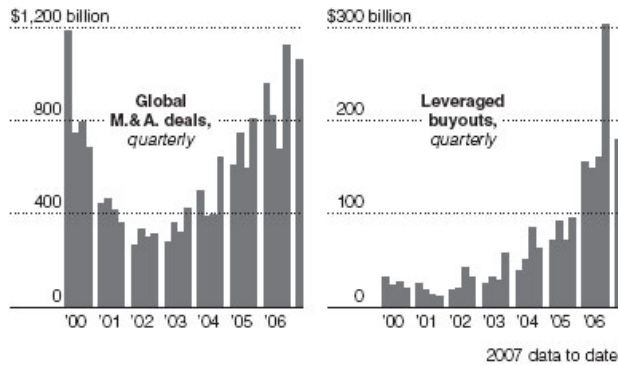
The past returns from Private Equity Funds have been mixed, however. Empirical evidence suggests that there is a huge discrepancy in performance among PE firms. While investing in an index of PE funds would fail to add sufficient value given high manager fees, the top quartile came in with average returns of 23%, and the best averaging 57%, far ahead of the equity indexes. Historically, the best returns from PE have come from investments that were initiated during a recession or the early stages of an economic recovery. Currently, we are at the other end of the economic cycle, perhaps indicating negative things to come. Additionally, as more and more PE firms enter the market, the price of target companies increases, further lowering the potential return to investors.

³ The "Money Flow" Myth and the "Liquidity" Trap, Weekly Market Comment, John P. Hussman, Ph.D., March 12, 2007

⁴ Andrew Ross Sorkin, "How to Show That You're No Gordon Gekko", The New York Times, March 25, 2007

Merger Boom

Deal making continues to hum along at an extraordinary clip. While slowing down slightly from the end of last year, the pace of merger activity so far this year is sharply exceeding that of a year ago, and 2006 was a record year.



Source: Thomson Financial Markets

2007 data to date. 5

Whether PE firms add value to companies they take over is subject of heated debate. Some PE firms buy companies, leverage their balance sheets, squeeze out profits as quickly as possible through leveraged “dividend recaps” and take them public again within a year. These public companies in turn tend to perform poorly. Other PE firms add value through operational improvements by restructuring management and their balance sheets and keeping these companies in their funds for long periods of time. These are the companies that tend to be the long-term winners.

The amount of leveraged loans outstanding that are associated with PE financing in the United States are at an all time high, at about \$1.3 trillion, and headed higher. This is also the case for high-yield debt, securitized mortgages, and collateralized debt obligations. With such high debt levels and credit quality beginning to deteriorate, default rates will naturally increase as, in fact, they have. On top of this debt problem on a National level, the global credit derivatives market is currently at \$25 trillion dollars, having been virtually non-existent 5 years ago.

Of course this commentary wouldn't be complete without sharing our thoughts on the initial public offering announcement of the private equity behemoth the Blackstone Group, which could value the firm at nearly \$40 billion. We find this role reversal a bit contradictory in an industry that has long championed the advantages of “going private.” Given the tremendous boom in buyout activity, it almost leads us to wonder if the private equity heavyweight is trying to cash out at the top. There is certainly no shortage of capital, so that argument will hardly fly. The guys that run these businesses are very smart, and the information scale is most often tipped towards the seller. Sellers almost always are driven to sell when they believe that they have maximized potential value. We think Time's Michael Kinsley says it well in his appropriately titled article “Abracadabra for Sale.”

“The consensus in the business world seems to be that Schwarzman and his colleagues may be selling full-price tickets to a ball game in the ninth inning, as the stock market fizzles out. These private-equity types are not in the habit of selling at the bottom. “I always think about what will kill off the other person,” Schwarzman once noted, charmingly.”⁶

There is no doubt the company could become a core holding in some portfolios, driving up the stock price on the opening of trading. However, with Blackstone putting up record profits of \$2.3 billion in 2006, it's hard to imagine that they can become more profitable given their sheer size and competition for new deals.

⁵ Peter Edmonston, “Deal Makers Are Setting a Torrid Pace for 2007”, The New York Times, March 30, 2007

⁶ Michael Kinsley, “Abracadabra for Sale”, Time, March 22, 2007

Pondering Corporate Profits

Since 2001, at the tail end of our last recession, corporate profits in the United States have enjoyed consistent quarter-over-quarter double digit growth. They currently stand at 12% of GDP, 33% above their historic average of 9%. This can be attributed, in our opinion, to several key factors. First, there has been a wave of corporate restructuring and reengineering on the part of management across the United States, resulting in leaner, more efficient operations through cost cutting efforts and, to some extent, relocating and outsourcing of operations. This has translated into healthier balance sheets and heftier profit margins. However, recent data released by the government suggests that the benefits of this cost cutting have reached their pinnacle as productivity in the United States has begun to deteriorate in the fourth quarter of 2006 and labor costs have begun to increase.

Second, global commodity prices have dramatically risen over this time period. These price increases all flow to the bottom line, greatly increasing profits and free cash flows for industries and companies that are greatly leveraged to the price of commodities. Third, legislative initiatives such as corporate tax cuts and credits have expanded the bottom line as well. Lastly, increased government spending on defense has tremendously boosted US corporate profits in the defense sector and the economy in general during this time period, elevating defense spending as a percentage of GDP from 3% to 6%. One can legitimately argue that this recent boom in the economy is pure textbook Keynesian stimulus at work and not free-market economics.



Ultimately, we believe that corporate profit growth will have to revert to the mean back into the mid-single digits. We also believe that if we make certain adjustments, current corporate profits are not as strong as they might perhaps appear. For example, in the fourth quarter of 2006, of the companies in the S&P that released earnings, the majority of growth in earnings collectively came from the financial sector. If we remove the financial sector from the S&P earnings, the earnings picture is, on the contrary, not as bullish for the general economy. One strong piece of government data that supports our thesis is the weak retail sales report that showed that retail sales increased by .01% in February, while a survey showed that economists were expecting an increase of .3%.

Another piece of recent evidence supporting our thesis is the durable goods number for January. The Federal government reported that orders for corporate machinery (capex), which represents 9% of real GDP, plunged in January by 7.8%. This capital expenditure slowdown is unusual for an economy whose major corporations have been experiencing double-digit corporate profit increases during the past 5 years. Over the past couple of quarters, the capex has downshifted noticeably, historically a sign of an impending slowdown in the overall economy. This capex is unlikely to pick up any time soon, as we believe consumer spending will likely continue to decrease in the coming months, for reasons we will explain below, and factory capacity utilization will decrease further as well. Contrary to our thesis, however, the labor markets do remain strong, with recent data showing initial jobless claims coming in at a healthy pace although the average work week is beginning to decrease. If the labor market and consumer sentiment remain strong, we believe our economy can experience a soft landing.

Something that one might not predict is that as corporate profits are increasing to record levels, corporate dividends as a percentage of corporate profits are heading in the other direction. The current dividend payout ratio is 29% and is the lowest in 12 years, even lower than the long-term

average of 47%. This is consistent, however, with the corporate cash stockpiles and stronger balance sheets in recent years. Management is less willing to commit to giving back to shareholders in the form of dividends, and prefers to keep cash on their balance sheet for future balance-sheet flexibility. Cash-rich balance sheets, however, as well as hefty free cash flows have made public companies the perfect targets of Private Equity firms in an environment of low interest rates.

Closing thoughts

In short, what keeps us up at night is the thought that all of the forces that have helped to lower risk premiums and lift asset prices in most classes over the last several years, including stocks, bonds, real estate and commodities, could be the same forces that lead to them to decline with tight correlation. The most recent decline in national home prices is the first in decades. In his March commentary, self-proclaimed Bond King Bill Gross notes a parallel between Agatha Christie's "Ten Little Indians" murder mystery and his own "Ten Little Assets" in his effort to understand what drives asset prices and ultimately which asset classes PIMCO believes will be affected first (and already have been) as a result of the "strangler" increase in overnight lending rate by the Fed to 5¼%. The first four, Yen, Bonds, Housing and Commodities, in that order, have already felt the pain. He believes (and we concur) that High Yield Mortgages, High Yield Bonds, Stocks, Emerging Market Bonds, Emerging Market Currencies and Private Equities (also chronological) are affected next. We believe that the Fed is well aware of this and has a close eye on asset prices, and as they are deflated, the probability of a rate cut increases.⁷

In view of the recent near-vertical move in global equity markets, we are not as bullish on the next six months. Although we will be positioning ourselves defensively, we will still be maintaining a moderate exposure to Global Equities, should they continue to rally on positive economic news. We believe that the US dollar will continue to weaken relative to other major currencies, as we believe the Fed will have to lower interest rates due to further Mortgage woes, and that will put further pressure on the dollar relative to other major currencies. We are therefore increasing our allocations to foreign fixed-income investments that should realize benefits from both foreign interest-rate increases and strengthening foreign currencies. Additionally, the recent pickup in volatility has increased our conviction regarding alternative investments, including hedge funds and select private equity and real estate investments, which provide consistent returns during turbulent times. We also favor various investments in commodities such as agricultural products, energy and precious metals.

Our absolute oriented total-return philosophy has continued to deliver solid results in diverse market environments. We remain devoted to uncovering profitable opportunities with a steadfast commitment towards risk management.

Respectfully,



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⁷ Bill Gross, Investment Outlook: Ten Little Assets, PIMCO, March 2007