

QUARTERLY
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

10 LARGEST HOLDINGS AS OF
SEPTEMBER 30, 2007

Large Cap Equity:

- Illinois Tool Works Inc. (ITW)
- Danaher Corp. (DHR)
- AFLAC Inc. (AFL)
- Halliburton Company (HAL)
- TD Ameritrade Holdings Corp. (AMTD)
- Bank of New York Mellon Corp. (BK)
- Cisco Systems Inc. (CSCO)
- L-3 Communications (LLL)
- SanDisk Corp. (SNDK)
- Corning Inc. (GLW)

Mid Cap Equity:

- Hologic Inc. (HOLX)
- Administaff Inc. (ASF)
- Oshkosh Truck Corp. (OSK)
- Apollo Group Inc. (APOL)
- Thomas & Betts Corp. (TNB)
- First Marblehead Corp. (FMD)
- Respironics Inc. (RESP)
- L-3 Communications (LLL)
- Kyphon Inc. (KYPH)
- UAP Holding Corp. (UAPH)

All Cap Equity:

- Kyphon Inc. (KYPH)
- Express Scripts Inc. (ESRX)
- Bucyrus International Inc. (BUCY)
- Parker Hannifin Corp. (PH)
- L-3 Communications (LLL)
- Halliburton Co. (HAL)
- Caterpillar Inc. (CAT)
- Corning Inc. (GLW)
- Janus Cap Group Inc. (JNS)
- PepsiCo Inc. (PEP)

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THE RORER REVIEW

"That Was Easy"

If you're a homebuilder, lender or retailer, the third quarter was truly a wretched experience. These industries felt the brunt of the fallout from the housing and credit crisis that finally reared its ugly head, after many months of anticipation. Also hurting is the transportation sector after having experienced deteriorating volumes for most of the year. Corporate chieftains of these industries went to the Fed with reports of recessionary conditions and an inability to access credit, begging for relief. Chairman Bernanke and his crew obliged with a cut in both the Fed Funds rate and the discount rate by 50 basis points. Our avid readers (and we know you're out there somewhere) may now be relieved that they no longer have to read in this space our forecasts of a housing crash, Fed rate cuts, and reasons why they've been delayed for just a little bit longer, for now they have (finally) come to fruition. However, for those invested in the 70% of the stock market outside of the financial and

consumer discretionary sectors, which were the only areas of negative returns in the quarter, one may reasonably be asking: Could it

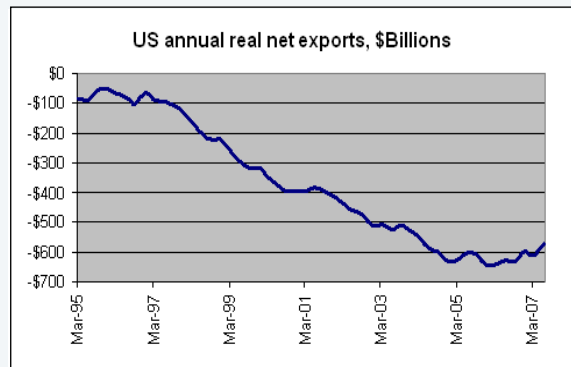
really be that easy? Seemingly the Fed pushed one of those red Staples (SPLS) "Easy buttons," of the 50 basis point variety, and all is now well with the world. For if that's all this bursting bubble has to offer, it certainly was not worth the anxiety or the wait. Indeed, as we enter October the stock market is back on a roll, ignoring a plethora of nasty news in soaring to new all-time highs. In fact the market was led

by the most cyclical sectors: Energy, Technology, Industrials and Materials. To explain this phenomenon we must look to how the increasingly global economy, as described in last quarter's report entitled "It's a Small World After All," enables our domestic markets' to share in the benefits of the European, Asian and emerging markets economic strength. At the same time, savvy financial engineers enable the sharing of risk and ultimately the ensuing pain of America's domestic turmoil with these same inauspicious trading partners. This is a trade-off not without risks and consequences, but for now equity investors and the U.S. economy are certainly enjoying the benefits of our interconnected, global system of shared fortunes.

In the third quarter the housing fallout spread in dramatic fashion not only to mortgage lenders, as one would expect, but also to the major investment brokerage firms, hedge funds, investors in asset-backed securities and banks regardless of their domicile. Virtually any business even indi-

rectly tied to the housing market saw its stock price plummet. Credit markets seized as access to short term lending dried up, and gov-

ernments all over the globe had to inject liquidity into the financial system just to keep it running. However, the Fed's aggressive actions restored relative calm to the markets, aided significantly by one of this era's most ingenious inventions: asset-backed debt securities. In these investments, loans of all kinds (notably home mortgages) can be purchased from banks, bundled together by varying degrees of



Source: Bloomberg

default risk, and sold off to investors all around the globe who are searching for higher yielding investments. The process worked fantastically for all players, including the lower income fellow who could now purchase a home via aggressive financing (often well beyond his affordability), because the risk of default could be passed far from the loan originator and shared amongst investors worldwide. As default rates accelerated this summer, the unfortunate corporations or investors who held these securities when the music stopped playing were forced to sell at huge losses. A few were even forced into bankruptcy. Further, many more firms will soon be required to disclose these investments at impaired market values when reporting dismal third quarter results. Displaying impressive resilience, the market no longer reacts negatively to the daily announcements of multi-billion dollar losses by various financial institutions worldwide. The global distribution of these losses has greatly mitigated the impact on any major individual financial institution, the financial system at large, and the U.S. economy.

This well-oiled global economy has offered the U.S. markets a few other lifelines: low inflation and a weak dollar. Inflation has cooled, contained by the ability of corporations to shift production to lower cost regions, which freed the Fed to respond aggressively. This has led to a growing belief, as the stock market's rise implies, that turmoil will be largely contained to the unfortunate few mentioned above. Meanwhile, the falling dollar appears to have reached a tipping point as it relates to our international trade balance. Evidence is mounting that U.S. manufacturers of products, ranging from industrial equipment to farm crops and even coal, are finding robust foreign markets for their products as the weak dollar makes their prices increasingly attractive. The result is that the trade deficit (see chart), after 15 years of consistent expansion, has now clearly begun to shrink. Maybe "Made in the U.S.A." still has some meaning after all. It's likely that a healthy, long-awaited realignment

of global growth is now rebalancing trade and capital flows between the U.S. and the rest of the world. European governments are increasingly concerned about their currency competitiveness. As a result they are now preparing to back off their hawkish monetary policy stances, adding fuel to the rapidly growing global money supply. This return of widespread stimulative monetary policies will only enhance the tidal wave of global liquidity, already amply supported by low global interest rates, commodity profits in emerging markets, alternative investment funds, and massive cash balances on corporate balance sheets. This liquidity will also need to find a new home. After the Fed cut interest rates, gold rose to a 27-year high and commodities, as measured by the CRB index, posted their biggest monthly increase in 32 years. However, we propose that attractively priced U.S. equities remain one of the most alluring destinations available.

This may all sound too "easy" to be true. While the bull market is following the playbook to date, substantial hurdles will make the road far less "easy" going forward. Though we still do not expect recession, we anticipate economic conditions will get worse before they improve. In the near term the housing crash is far from finished and tighter credit conditions will hamper consumer and possibly corporate spending capabilities. Layoffs in the financial sector have just begun, and a weaker employment environment in our near future, along with lower home values, will certainly put a temporary damper on consumer spending. After offering U.S. companies a bounty of profits in 2007, Europe's pace of robust growth may soon be curtailed by a strengthening currency, which will limit their ability to export goods. However, these risks are well documented and to a great extent now expected by a stock market willing to look beyond the storm clouds to the sunshine that lies ahead. Moreover, it's highly likely that the baton of economic leadership will now fully be passed to China and other emerging markets where growth prospects power

forward, still unabated by the slowing of developed economies. While some negative impact should be expected, emerging economies are less dependent on the developed world to sustain their growth than at any time in the past as self-sustaining, wealth-driven growth in their domestic consumption has emerged. We feel this powerful trend will provide significant fuel to keep recession at bay, along with the lifelines mentioned above, until the U.S. economy can regain its footing after a classic, mid-cycle pause.

As for new predictions, we're content to state that non-recessionary Fed rate cutting cycles, much like the mid-90's, are very much correlated with strong stock market returns. Despite slowing profit growth, valuation multiples tend to expand. Unfortunately, given the lack of a meaningful correction in stocks to date (despite the angst, we saw less than a 10% drop in the major indices from the July peak to the August bottom), it's likely the path ahead will have some volatility. Earnings have slowed to low single digit growth, which should lead to a divergence in fortunes amongst individual companies, some better positioned than others to grow on the more challenging road ahead. Savvy investors will do well by focusing on companies that will remain unfazed by this unprecedented housing crash or that have been punished for unfounded "guilt by housing association."

At Rorer we'll look to our relative value and earnings momentum models to identify stock bargains with earnings prospects diverging above those of their peers. Meanwhile our fundamental analysts will strive to uncover companies with secular or company-specific growth drivers which have gone unrecognized by the market. While there is no "easy button" designed to navigate these tumultuous times, we're appreciative of our clients who've entrusted us to handle the task.

The views expressed represent the opinions of Rorer and are not intended as a forecast or guarantee of future results.

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The Ten Largest Holdings are not investment recommendations and may no longer be held in account portfolios.