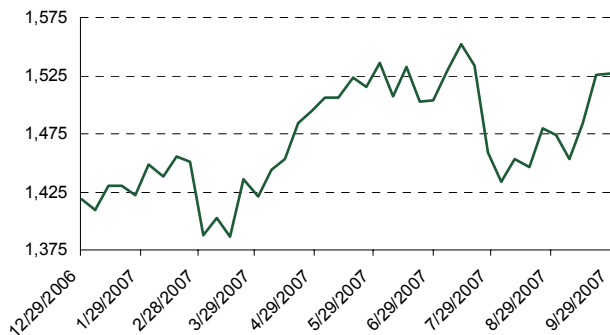




## Financial Review

In the third quarter, the financial markets weathered a surge in volatility as a deepening financial crisis in the sub-prime mortgage market threatened to spread to the broader economy. The Federal Reserve changed its course on interest rates, providing liquidity to a market suddenly in trouble. Stock markets across the world reacted strongly to the action by the Fed (and other central banks) - quickly recovering from the August lows.

S&P 500 Index  
Weekly



The S&P 500 Index managed to rally for a 2% gain in the quarter, bringing the year to date return to 9.1%. The Russell 2000 Index, however, declined 3.1% in the quarter, cutting the return on the small cap benchmark index to just 3.2% YTD. International stocks, as reflected by the Morgan Stanley EAFE Index, rose 2.2% for the quarter and have surged 13.2% YTD.

The brief instability of the markets in the third quarter reminded investors that investing in securities involves various levels of risk. The current bull market has lasted five years, with the S&P 500 Index more than doubling in value over this time period. As is

typical in the later stages of a bull market, some investors grow increasingly confident about the certainty of future returns, thereby seeking strategies to increase returns. When leverage is used as a method of increasing returns, a brief hiccup in the financial markets is usually all it takes to generate a few high profile victims. This quarter was no exception, as a few hedge funds were forced into liquidation, and several financial institutions either went bankrupt or required emergency funding to avoid that fate.

At this point, it is probably premature to state that the crisis originating in the housing and sub-prime markets has been completely averted. However, the response by central banks around the globe has sent a signal to investors that the banks will now promulgate policy to add liquidity, if necessary, to keep the markets operating effectively. This should bode well for equity investors at least for the remainder of the year.

## Core Equity Portfolio

This past quarter, we initiated positions in Sun Microsystems, Walgreens, and Weyerhaeuser.

Sun Microsystems is a leading provider of network servers and related services. Once regarded as a “must own” technology stock in the 1990s, Sun’s share price declined over 90% from its high in 2000 as demand for their high-end servers dropped precipitously. Currently, we believe the company is finally positioned to exceed market expectations for profit growth as their margins are poised to

expand. Additionally, the company has initiated its first buyback program since 2002. At recent prices, we believe the risk/reward is decidedly in our favor.

Walgreens is the largest retail drugstore chain in the U.S., currently operating 5,800 stores and adding 400 net new stores per year. Walgreens is a beneficiary of several long-term demographic trends: an aging population, increased usage of drugs for treatments, and a shift toward higher margin generic drugs. We expect earnings growth to average in the low to mid teens over the next five years. The price-earnings multiple for the stock has been cut in half over the past 7 years to a level we believe is compelling for a long-term investment.

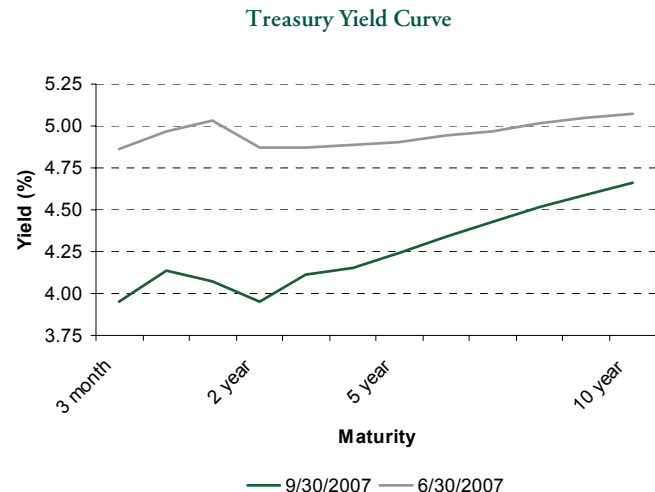
Weyerhaeuser is a diversified forest products company, with operations that include growing and harvesting timber, as well as the manufacture, distribution and selling of wood products. Concerns over the recent decline in the housing/construction markets have put downward pressure on the shares. The stock has a number of potential catalysts on the horizon, including converting to a REIT structure or legislative tax reform. Trading at a discount to the net asset value of its businesses and properties, we believe movement toward any of these catalysts will help the market recognize Weyerhaeuser's growing asset value. Until then, shareholders will benefit from the stock's attractive dividend yield of 3.4% (which has grown over 8% annually over the last 5 years).

During the quarter, we sold our investments in Alltel, Dell, and Hubbell. Alltel owns and operates a national wireless network, primarily in rural geographies. In May, the company announced it was to be acquired by a consortium of Private Equity companies for cash. Although under normal circumstances

we would hold the stock until the closing of a cash acquisition, in the recent credit climate we decided it was prudent to sell our position early to lock in our gains. Dell, a provider of computer products and services, was sold in favor of our investment in Sun Microsystems. Although we feel the company is making progress toward improving customer service issues and maintaining market share, we believe the recent recovery in the share price discounts future progress. Hubbell, a manufacturer of electronic products, was sold when the stock met our price objective.

### Fixed Income Markets

Interest rates declined in the third quarter, as weakness in sub-prime financial products generated concern that the broader economy was on the verge of recession. The Federal Reserve, increasingly worried about the stability of the economy, moved to lower rates for the first time in four years. On September 18<sup>th</sup>, the Fed lowered the Fed Funds rate 50 basis points to 4.75%. The move by the Fed, along with other central banks providing liquidity around the world, calmed financial markets and brought liquidity at a critical time.



September 30, 2007

We believe the Fed was quite reluctant in making this move, and barring signs of broader economic weakness, we expect the Fed to hold rates through the end of the year. We are keeping portfolio duration near benchmark levels.

## Alternative Investments

Alternative investments had a mixed quarter. Volatile market conditions caused a wide dispersion of returns by sectors and managers.

**Equity Long/Short** performance depended heavily on how each manager reacted to the downturn in August and subsequent rally. Highly leveraged funds that were forced to liquidate fared worse than more conservative products, and managers with a large exposure to emerging markets posted the best results.

Given the shut down in the deal pipeline and uncertainty facing previously announced buyouts, **Merger Arbitrage** managers fared surprisingly well in the quarter. Spreads narrowed as the quarter progressed, and to date there have been relatively few broken deals.

**Long Credit** was one of the hardest hit segments in the quarter. Spreads widened across the yield curve in nearly all geographies, and regardless of the underlying credit quality, managers were forced to mark down the value of their positions. For the first time in years, **Distressed Security** managers began preparing for a new investment opportunity in the residential mortgage area.

**Commercial Real Estate** prices have experienced some pressure due to what we would view as more rational debt funding options, but overall demand for space remains high. This has created a favorable

environment for triple-net-lease funds and other alternative lenders who are experiencing less competition and better initial returns on new transactions.

## One Year Economic Overview

		Sep 2007	Sep 2006
<b>Stock Market</b>			
S&P 500 Index	▲	1,526.75	1,335.85
Russell 2000 Index	▲	805.45	725.59
<b>Fixed Income Yields</b>			
3-Month Treasuries	▼	3.95%	4.98%
5-Year Treasuries	▼	4.24	4.55
10-Year Treasuries	▲	4.66	4.63
30-Year Treasuries	▲	4.84	4.75
<b>Inflation Monitor</b>			
CPI-Trailing 12-Month Growth	▼	2.0%	3.8%
CPI-(Excluding Food/Energy)	▼	2.1	2.8
Market Expectations*	▼	2.4	2.4
Gold (per ounce)	▲	\$743.60	\$598.30
Crude Oil (per barrel)	▲	81.66	62.91

\*Comparison of yields for 10-Year Treasury and 10-Year TIPS

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