

The causes and catalysts for last week's dramatic decline were well-documented in each of our recent Outlooks and quarterly commentaries. They included the debacle in the sub-prime and CDO markets, the market's dependence on extreme levels of liquidity, the needed restoration of a risk premium into higher-risk asset classes, and the dangers of a highly-leveraged global economy. We knew what and we knew why. What we did not know was what catalyst would ultimately cause the markets to finally acknowledge these problems, and when it would happen.

In retrospect, the catalyst seems to have been the implosion of two very highly leveraged Bear Stearns hedge funds that specialized in sub-prime securities and CDOs (Collateralized Debt Obligations). Those occurrences caused an almost immediate credit contraction in the more speculative parts of the bond, mortgage and structured product markets, and illustrated to investors that, without liquidity and a willingness of investors to invest in these more speculative assets (at almost any price), there is virtually no way to trade or even price them (aside from computer models that suggest what they might be worth, if there was sufficient liquidity).

Investors reacted as they normally do when faced with uncertainty; they discounted the worst case scenario into securities prices and produced last week's decline. In doing so, investors also validated an old Wall Street adage, "when you can't sell what you want, you sell what you can", and investors took profits where profits were the largest. In last week's case, this included a dramatic sell-off in energy and basic materials-related stocks, which have led the domestic bull market over the last several years.

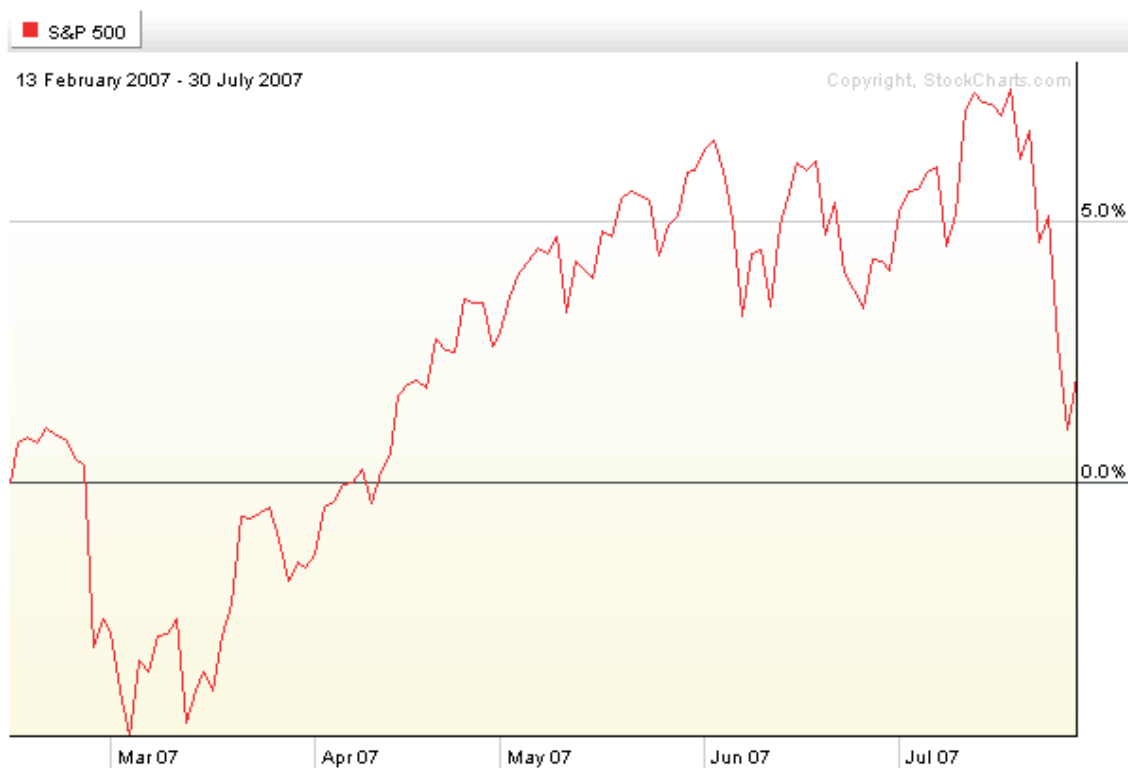
According to TrimTabs, last week produced the biggest withdrawals from domestic mutual funds since July of 2002. Over the same period, U.S. corporations bought back the largest dollar amount of their own shares since the markets re-opened after the 9/11 attacks. The "smart money" was buying while the small investor was panicking.

We believe that last Friday probably marked the low for this decline. However, it is normal for markets to "re-test" their lows (see the March correction on the chart) before they can move sustainably higher. The next few weeks should be very enlightening in regard to future trends.

From a macro-economic perspective, the economic and market fundamentals continue to be quite strong. We remain in the most powerful and broadly-based economic expansion in human history. Liquidity, while contracting on the margin, is still plentiful. Interest rates, while moving generally higher, are still historically low. Profit growth, while slowing in the U.S., is still robust on a global basis, and, aside from the Chinese Shanghai Composite, global stock market valuations remain quite modest. As we noted in the last Outlook, the fundamentals remain quite good, they are just no longer perfect. Based on these and other generally benign macro-economic factors, we believe that the primary bull market in global equities remains intact. Indeed, the markets are arguably much healthier as a result of this decline. They have now started the process of correcting the previous excesses in sentiment, valuation and risk tolerance, which should help the long-term sustainability of the current bull market.

At the same time, we suspect that last week's decline was insufficient to fully discount the sub-prime and CDO problems into the global stock markets (not all of the bad news is out yet). Instead, it was likely just the second

of what we expect may be a series of potentially violent, short-term corrections, as part of what should be an increasingly volatile bull market. The first such decline (related to liquidity fears) occurred at the beginning of March. That decline was driven by a February interest rate hike by Japan, and concerns about the effect that it would have on the Japanese “carry trade”, and thus global liquidity and the debt markets.



From our perspective, the markets are still likely to receive a steady flow of bad news about the real estate, sub-prime, and CDO markets for at least the next few months. This news flow is likely to both increase market volatility and catalyze other short-term declines, but within the context of a generally upwards trend. We are witnessing a de-leveraging of a significant segment of the U.S. financial system, and are seeing a re-rating of lower-rated and higher-risk securities so that their prices more accurately reflect their risk relative to higher-quality securities. In market terminology, credit spreads are widening. This is likely to take some time for the markets to fully digest.

Further, we will be on the lookout for signs of “contagion”, where problems in these debt markets bleed over into the other financial markets and the global economy. We have already witnessed two private equity deals over the past week, where the banks had to provide bridge loans (basically buy the debt themselves) because investors were unwilling to buy the bonds necessary to finance the deals. This “credit crunch”, albeit probably temporary, is likely to hinder private equity transactions and slow somewhat the removal of equities from the public markets. On the other hand, corporate share repurchases remain very strong. Over the past year, U.S. corporations have spent more money repurchasing their own shares than the federal government has spent on Medicare.

For the time being, we are advocating a slightly more defensive stance, but only slightly. Even if Friday does not represent the lows of this correction, we believe that it is simply too late to raise significant cash. Instead,



we believe that it is time to build your shopping list, with a particular emphasis on sectors. In general, we are very cautious on any sectors that are likely to be directly impacted by this de-leveraging and re-rating. This includes homebuilders, Real Estate Investment Trusts, financial services companies, consumer-discretionary companies and almost any lower-quality debt instrument (as examples).

By contrast, there are groups, which may be indirectly impacted by these debt issues, but where the fundamentals appear to be strong enough to more than overcome these negative influences. In addition to technology and heavy industry stocks (industrials), whose exporting competitiveness is benefiting greatly from the dramatic slide in the value of the U.S. dollar, we expect for the previous leadership sectors to re-emerge. This includes energy stocks, basic materials stocks, and emerging market stocks. We believe that these five areas are being driven primarily by the explosive growth in the world's emerging economies (and the strong global growth generally), and are thus less dependent on the domestic economy for growth and profits. We also like the prospects for smaller (non-financial and non-exporting-oriented) foreign stocks.

While we expect for equity market volatility to increase (to more normal levels from a historical perspective), and while we expect for certain parts of the market to struggle as the full extent of the sub-prime debacle unfolds, we do not yet see any indications that this issue will be sufficient to unseat either the global bull market or the global economic expansion. As such, we currently view any of these downturns as buying opportunities. Indeed, while this bull market is admittedly old from a chronological perspective, we maintain our stance as “nervous bulls”, and believe that this bull market will ultimately continue to surprise most investors in terms of both its duration and its upside potential.

The CACH Asset Management Team



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