



Former bond market commentator, Ed Hart, was famous for talking about periods in the markets “when the demand for certainty far exceeds the available supply”. If Mr. Hart were alive today, we are confident that he would agree that this is one of those times. For our part, there are certainly elements of the current market correction that are unfolding differently than we had anticipated in our most recent Outlook.

With this in mind, we wanted to update you on this fast developing situation and to provide you with an update on our current thinking. In our writing of two weeks ago, we noted our belief that the markets had potentially already sufficiently discounted the Bear Stearns hedge fund news, and that we were likely to experience a period where the markets could stabilize and ultimately move higher before they would be hit by the next inevitable revelation of sub-prime/CDO-related problems.

The markets were never given that opportunity to stabilize, much less rally. Within hours after the writing of that commentary, American Home Mortgage announced the first in a growing stream of mortgage company bankruptcies. In addition, the sub-prime/CDO issue has since led to major problems in banks and hedge funds ranging from America to Australia, and, most recently, to continental Europe.

As the fundamental causes of the current decline are well documented in our last several reports, we will not repeat them in great detail here. However, the symptoms related to these causes are quickly evolving.

In the most basic of terms, we are seeing the unwinding of several years of unbridled credit expansion and systematic leverage. This condition created a situation where investors were largely indifferent to risk, and thus where higher-risk assets were being priced similarly to high-quality assets. This ongoing correction is the market's way of restoring the risk premiums into these lower-quality assets and of punishing those that did not consider/understand risk when selecting their investments. Unfortunately, such market adjustments also tend to wound a great many innocent by-standers.

From our perspective, this issue has both an acute component and a more chronic element. The more chronic element includes the facts that 1) there needs to be a restoration of appropriate risk premiums into higher-risk assets, and this painful process is likely to last for months; 2) there are billions of dollars of potentially worthless debt that is on the books of the world's financial institutions and hedge funds, and this debt will ultimately need to mark-to-market, which may potentially cause billions of dollars in currently undisclosed losses; and 3) that the market's 80-mile-per-hour liquidity tailwind has, at least temporarily, been replaced by a credit crunch.

It is the credit crunch that is the acute part of the problem. Banks have been unwilling to lend to each other (a necessary and regular practice) at the targeted Fed Funds Rate. Mortgage interest rates are moving sharply higher and mortgage underwriting has become restrictive. “Jumbo” mortgage programs (\$417,000+ mortgages) are now largely unavailable, and the illiquidity in the mortgage markets is exacerbating the bear market in residential real estate prices. More importantly, defaults are starting to spread into the prime mortgage market, and there are entire segments of the debt markets that simply do not have sufficient liquidity to trade. Inefficiencies and liquidity problems are showing up across much of the global financial system as a result of this credit crunch.

In our opinion, it is this credit crunch that is primarily responsible for the severity and indiscriminate nature of this decline. On Friday the 10th, we believe that we witnessed the beginning of the end to this acute problem. The global central banks finally started responding to this issue with the single best solution to a credit crunch...money.

It started with major currency injections by the Bank of Japan and European Central Bank, and assurances from other central banks that they would provide all necessary liquidity. This was followed in the U.S. by the Federal Reserve injecting a massive \$38 billion of short-term liquidity into the banking system. The Fed actually needed to inject money three separate times on Friday before they could ultimately drive the Fed Funds rate down to their target, which should help to free-up inter-bank lending and resolve some of these acute liquidity issues. This is the first time that the Fed has injected emergency liquidity into the system since the days immediately after 9/11.

Interestingly, this is also the first big test of Fed Chairman Ben Bernanke's leadership, and his first chance to prove himself as a worthy successor to Chairman Greenspan. Greenspan had decades to build credibility with the markets, and investors had confidence in his willingness to do whatever was required to maintain financial stability.

By contrast, Ben Bernanke is still trying to prove himself as an inflation fighter. As such, we believe that he would strongly prefer not to lower interest rates, and to rely solely on these short-term liquidity injections to re-liquify the financial markets. If he is able to re-liquify the system via these short-term injections, and thus not be required to lower rates, this is likely to disappoint a great many investors. According to the Fed Funds futures contract, investors are pricing in a better than 100% chance of a rate cut in September, and a likelihood that it will be of more than the standard .25% (25 basis points).

The bad news is that the markets are likely to sell-off further if they do not get the rate cut that they are expecting (another short-term risk). The good news is that the world's central banks are now both involved and committed, and we don't think that, once in, they can remove themselves from this issue until the acute, panic and credit crunch-driven element of the correction has stabilized.

This is not to suggest that the central banks have either the ability or the desire to make all of the more chronic issues disappear. Indeed, they want to let the self-correcting nature of the capitalistic system work, and they certainly do not want to bail out investors who only thought about profits and forgot about risk. The free market needs to be allowed to do its job, which is to remove these excesses from the system and restore rationality to securities prices, and the current credit crunch has been keeping many markets from efficiently fulfilling this role.

No, the central banks are not likely to make the problems go away, and we do not believe that central bank involvement will cause an end to the selling. However, we do believe that it will ultimately bring to an end the indiscriminate selling that has been so pervasive during this decline, and create an environment where investors are able to differentiate between "good" and "bad" investments. This should create ample opportunities to invest in the many compelling areas that we believe have been unjustifiably sold off during this decline.

Unfortunately, we suspect that, in the very short run, even many investments with attractive fundamentals



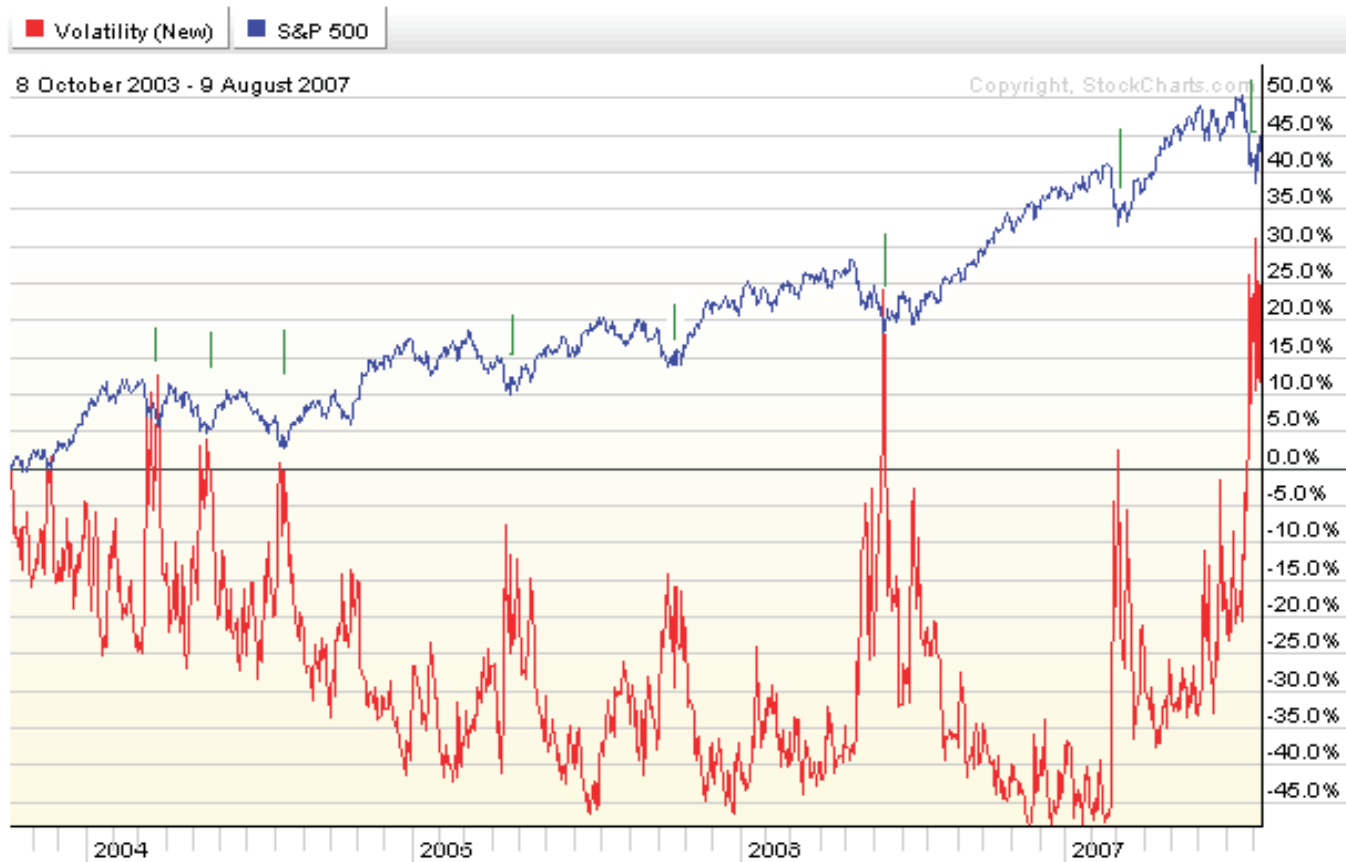
may be subject to ongoing selling pressure. Indeed, many of the best, most liquid stocks are being used as a source of funds simply because they can be. They are being sold because their strong fundamentals are keeping them liquid when less-attractive securities are illiquid. “When you can't sell what you want, you sell what you can”, as the old saying goes.

This is a particular issue for the many hedge funds that loaded up on CDOs and other sub-prime-related investments, which presently can't be sold. Further, it is expected that many of these hedge funds will face significant redemptions at the next redemption notification window on 8/15, and they may need to sell their “best”, most liquid securities in order to meet those expected redemptions.

While the macro-economic factors underlying the markets generally remain quite bullish for global equities, we are seeing some signs that this financial system problem is starting to bleed into the other areas of the world economy. It is too early to determine if the current decline is just a needed correction in valuations, leverage and credit within an ongoing bull market, or if it is the beginning of a cyclical bear market. The answer should become increasingly evident over the course of the coming weeks and months, which we anticipate will be a period of tremendous volatility.

It is particularly challenging to anticipate the ultimate scope and timing of this correction, as so much of what is causing the turmoil is emotional rather than fundamental.

In the following chart, you will see a comparison of the Standard & Poor's 500 Index and the VIX Index (aka the “fear index”). The VIX measures investor fear and the prices that investors are willing to pay for downside



protection. One of the interesting implications of this index is that it tends to peak concurrent with market bottoms. We have marked each of the recent VIX spikes with a green vertical line. While there is not a specific VIX reading that signifies that enough fear exists to signify a selling climax (aka a bottom), you can clearly see that spikes in the VIX have historically accompanied very good buying opportunities. Further, you can see that the current levels of investor fear, as represented through options, is at the highest levels since the bear market lows, and that the biggest spikes in the VIX have generally preceded the biggest gains in the markets. While this does not yet identify a bottom, it does suggest that the markets are setting up for a significant buying opportunity once this decline runs its course. Unfortunately, it is looking more and more likely that the path of least resistance is now to the downside, and that this condition may very well continue through the third quarter.

We will continue to watch the markets very closely and take our cues from the changing fundamental and technical environment.



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