

Equity Research

FINANCIAL

December 10, 2007  
Research Note

**Mark Lane**  
(312) 364-8686  
mlane@williamblair.com

**David Long, CFA**  
(312) 364-8435  
dlong@williamblair.com

**D.J. Neiman, CFA**  
(312) 364-8852  
dneiman@williamblair.com

## Financial Services Group

### Outlook and Top Picks for 2008 and the Next Three to Five Years

#### --Highlights

- William Blair & Company's Financial Services Research Group issued its outlook and top investment ideas for 2008 after the market close on December 6: American International Group (AIG), CME Group (CME), IntercontinentalExchange (ICE), Affiliated Managers Group (AMG), National Financial Partners (NFP), Assured Guaranty (AGO), Argo Group (AGII), and Signature Bank (SBNY) (in order of market capitalization). We also updated our long-term list (3-5 years), replacing Investors Financial (acquired by State Street [STT \$79.68]) with Northern Trust (NTRS), and SLM Corp. (SLM) with T. Rowe Price (TROW).
- Depending on how you cut the numbers, 2007 (through 12/4) has been the worst year of performance for financial services stocks since 1987 and Black Monday, when the Dow dropped 23% in one day. This performance has been driven by a complete meltdown in the subprime RMBS market, which has stoked fears in credit markets more broadly and concerns about the potential spillover impact on the overall economy.
- While our 2007 lists were positioned to be more defensive than our 2006 lists, both were weighed down by credit-sensitive stocks. Our 1-year and long-term lists continued to outperform their relevant financial services benchmark, although failed to outperform broader market indices for the first time, given significant underperformance in financial services stocks as a group and too much exposure to credit markets.
- Our investment approach continues to be bottoms-up—we are not making macroeconomic forecasts—although we are cognizant of the challenges. The outlook for financials heading into 2008 is as ambiguous as it has been any time over the past four years, in our opinion. We expect continued volatility in the near term, as the financial markets adjust to Fed easing and look for signs of stabilization in the residential mortgage market.
- We continue to embrace some balance on our one-year list by selecting names from different segments, including defensive, defensive growth, and some credit-sensitive names. We therefore expect some variability in share price performance within the list, given that the drivers of these segments can be very different.

**--Overview**

**Tough Year for Financials**

William Blair's Financial Services Research Group issued its 2008 outlook presentation on December 6 after the market close that included our top investment ideas for the new year (please contact your William Blair & Company salesperson for a copy of the presentation). The report also includes an update to our list of best ideas over the next 3-5 years. Our research universe covers a broad representation of financial services, including asset management, brokerage/exchanges/investment banking, commercial banking, financial guaranty, insurance (property-casualty and life), securities/custody banks, and specialty finance (consumer and commercial).

While it was better to categorically avoid credit-sensitive stocks in 2007, both our lists continued to outperform their relevant financial services benchmark, although failed to outperform broader market indices for the first time, given the significant underperformance in financial services stocks as a group and too much exposure to credit markets. Our list was initiated on December 6, 2006, and performance was measured through December 4, 2007. During this period, the S&P 500 Financial Index declined 15.1% and the S&P 500 Index increased 5.1%. Depending on how you cut the numbers, 2007 was the worst year of performance for financial services stocks since 1987 and Black Monday, when the Dow dropped 23% in one day. The performance was driven by a complete meltdown in the subprime RMBS market, which has stoked fears in credit markets more broadly and driven concerns about a potential recession.

**Financial Services Group  
Performance by Segment for 2007**

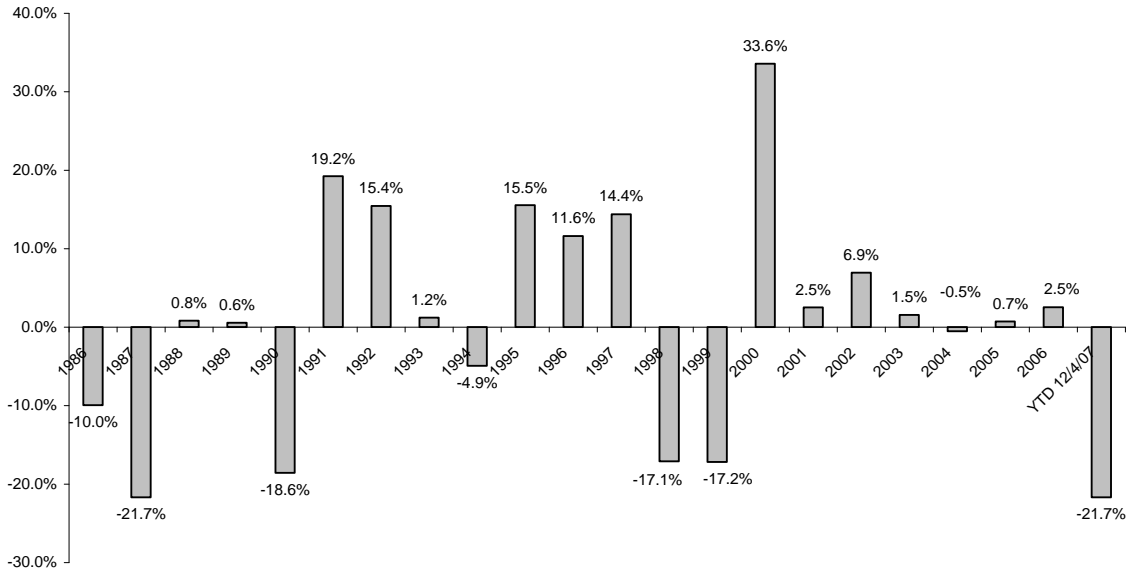
Indices	Performance <sup>1</sup>		Comments Regarding Prior 12 Months
	12/6/06-12/4/07	12/7/05-12/6/06	
S&P Financials	-16.5%	14.2%	Concerns about subprime RMBS market, rising credit losses, and overall U.S. economy
S&P 500	3.9%	12.4%	
Consumer Finance	-15.5%	4.4%	Concerns about mortgage market and overall rising consumer credit losses
Securities/Custody Banks	18.7%	18.2%	Strong equity markets globally, IFIN acquisition, and increased transaction activity
Major Investment Banks	-22.7%	39.3%	Concerns about subprime RMBS market and overall environment given changes in credit markets
Exchanges	35.1%	61.5%	Consolidation, beneficiaries of increased market volatility, and favorable financial characteristics
Comm'l' P/C Underwriting	1.8%	9.1%	Strong earnings and defensive characteristics offset by concerns about increasing price competition
Asset Management	15.8%	16.3%	Strong "global" equity markets and very transparent business model
Financial Guaranty	-58.4%	12.2%	Major concerns about subprime RMBS exposure and impact on sustainability of business model
Life Insurance	10.8%	10.3%	Strong performance by several large cap companies. Defensive characteristics appealing
S&P Banks	-27.1%	10.8%	Concerns about subprime RMBS market, rising credit losses, and overall U.S. economy
3-month LIBOR <sup>2</sup>	-3.7%	20.0%	

<sup>1</sup>Diversified groups are market capitalization weighted.

<sup>2</sup>3-month LIBOR decreased from 5.35% at 12/7/06 to 5.15% on 12/4/07.

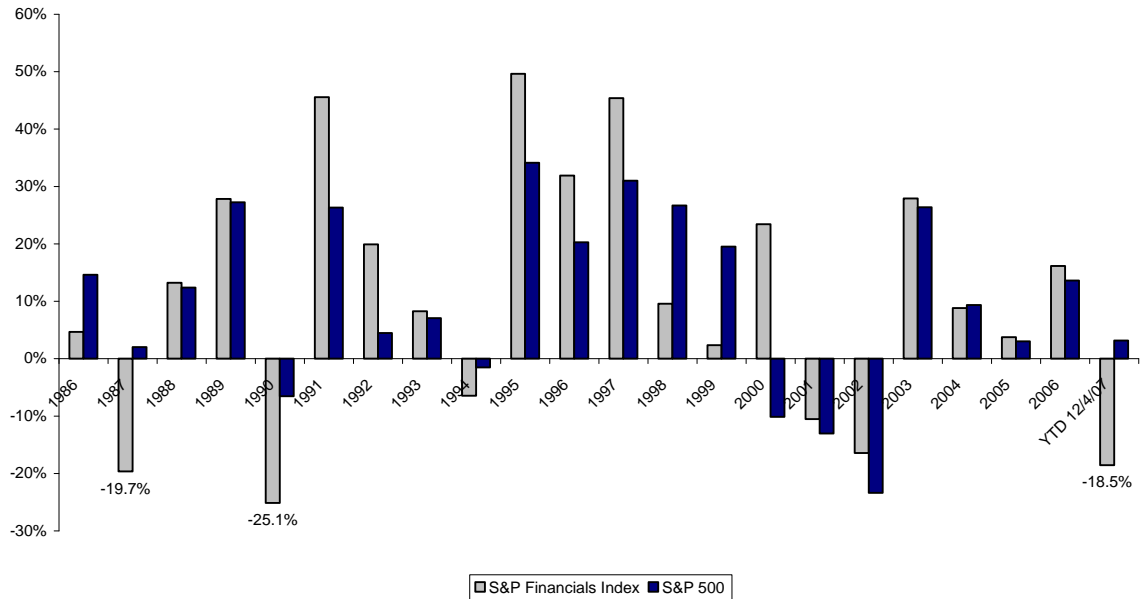
Source: FactSet, William Blair & Company research

**S&P 500 Financial Index vs. S&P 500  
Relative Performance Differential**



<sup>1</sup>2007 performance measured through December 4, 2007.  
Source: Bloomberg

**S&P 500 Financial Index vs. S&P 500  
Annual Performance Comparison<sup>1</sup>**



<sup>1</sup>2007 performance measured through December 4, 2007.  
Source: Bloomberg

The outperformance for our one-year list (5 names) was led by Northern Trust (up 39%) and Affiliated Managers Group (up 22%). Both of these names also outperformed their peer groups. Northern Trust benefited from broad strength in global equity markets, strong new business wins, and increased

transaction activity, given more volatile financial markets, principally foreign exchange. Credit quality at Northern also remains excellent. AMG benefited from strong international equity markets (35% of EBITDA from international), strong net inflows into international funds and alternatives, and the announcement of two recent acquisitions—value manager Cooke & Bieler and activist investor ValueAct Capital. AIG and Security Capital were weighed down by subprime RMBS concerns and PrivateBancorp was hampered by an inverted yield curve early in the year, slower-than-expected loan growth, and rising nonperforming loans from its exposure to residential developers.

**Financial Services Group Best Idea List 2004-2007**

<b>2007 One-year List Average (unweighted)</b>	<b>-10.9%</b>
S&P Financial Index	-15.1%
S&P 500 Index	5.1%
<b>2006 One-year List Average (unweighted)</b>	<b>18.9%</b>
S&P Financial Index	14.2%
S&P 500 Index	12.4%
<b>2005 One-year List Average (unweighted)</b>	<b>11.1%</b>
S&P Financial Index	6.2%
S&P 500 Index	6.3%
<b>2004 One-year List Average (unweighted)</b>	<b>37.3%</b>
S&P Financial Index	3.1%
S&P 500 Index	4.5%

Our long-term list performed better (8 names), benefiting from the takeover of Investors Financial by State Street (up 70%), strong performance from Affiliated Managers Group (up 22%) and CME Group (up 29%), and positive performance from Goldman Sachs (up 8%). Negative performers were driven by subprime RMBS concerns (Ambac and AIG), PrivateBancorp, and the failed takeover of SLM Corp. We take a long-term view regarding the 3-5 year list. As a result, we were willing to stick with certain names on our long-term list during 2006 that we believed would face more difficult market conditions in 2006. Investors Financial was facing pressure from an inverted yield curve and SLM Corp. was suffering from potential negative regulatory changes. However, the decision to stick with both of these names aided overall performance dramatically during 2007.

**Financial Services Group 3-to-5-Year List 2004-2007**

<b>2007 3-5 Year List Average (unweighted)</b>	<b>-1.2%</b>
S&P Financial Index	-15.1%
S&P 500 Index	5.1%
<b>2006 3-5 Year List Average (unweighted)</b>	<b>19.6%</b>
S&P Financial Index	14.2%
S&P 500 Index	12.4%
<b>2005 3-5 Year List Average (unweighted)</b>	<b>14.8%</b>
S&P Financial Index	6.2%
S&P 500 Index	6.3%
<b>2004 3-5 Year List Average (unweighted)</b>	<b>8.2%</b>
S&P Financial Index	3.1%
S&P 500 Index	4.5%

### Many Challenges Facing Financials Heading Into 2008

The outlook for financial services companies heading into 2008 is as ambiguous as it has been any time over the past four years, in our opinion. Consensus expectations reflect a marked slowdown in GDP growth starting in fourth quarter 2007, rising corporate and consumer credit losses in 2008, stable inflation, a modest uptick in the unemployment rate, and a continued reduction in short-term fed funds rates. The expectation for Democratic success in the upcoming Presidential election provides no clarity, and the weak U.S. dollar is causing general anxiety. We expect continued volatility in the near term, as the financial markets adjust to Fed easing and look for signs of stabilization in the residential mortgage market. It is too early to assess the efficacy of any government supported strategy to mitigate the risk of increasing residential mortgage defaults.

Most importantly, confidence has been shaken, given the deterioration in the residential mortgage market and therefore accommodative fed policy has not had the desired impact as of yet. Fed funds futures imply the Federal Reserve lowers interest rates by at least 25 basis points on December 11, 2007 (30% probability of a 50-basis-point cut), which would put the fed funds target no higher than 4.25%, down 100 basis points for the year. While financial services stocks have always outperformed over the course of any Fed easing cycle as a group, performance early in the cycle is more mixed, and more economically sensitive businesses can continue to trade poorly if business and economic conditions deteriorate in the near term. This trend occurred in the early 1990s and has occurred so far in the current cycle (see presentation for full analysis).

We continue to embrace some balance on our one-year list by selecting names from different segments, including defensive, defensive growth, and some credit-sensitive names. We therefore expect some variability in share-price performance within the list, given that the drivers of these segments can be very different. We adopted a portfolio/diversified approach. Our goal is to outperform financials and the overall market if financials do not significantly underperform. We have included more stocks (8) than in past lists (typically 5 to 6), given the ambiguity of the environment. We continue to see strong relative growth and secular prospects in segments such as alternative investments, asset management, emerging markets insurance, global derivatives, global securities/custodial services, and international capital markets development. Our three-to-five-year list more closely matches these themes. For our long-term list, we replaced Investors Financial (acquired by State Street) with Northern Trust, and SLM Corp. with T. Rowe Price.

#### Financial Services Group Best Stock Picks for 2008

Company	Ticker	12/5/07 Market Cap	Rating/ Profile	12/5/07 Price	2007E EPS	2008E EPS	2008 P/E	Div. Yield
American International Group	AIG	\$141,908	O/C	\$58.15	\$6.23	\$6.60	8.8x	1.4%
Chicago Mercantile Exchange	CME	\$35,133	O/C	\$697.25	\$14.50	\$17.85	39.1x	0.5%
IntercontinentalExchange	ICE	\$11,294	O/A	\$171.50	\$3.56	\$4.70	36.5x	0.0%
Affiliated Managers Group	AMG	\$3,678	O/C	\$123.01	\$6.85	\$8.10	15.2x	0.0%
National Financial Partners	NFP	\$1,794	O/C	\$46.68	\$3.00	\$3.55	13.1x	1.5%
Assured Guaranty	AGO	\$1,482	O/C	\$21.89	\$2.63	\$2.60	8.4x	0.7%
Argo Group	AGII	\$1,182	O/A	\$38.57	NA	\$4.00	9.6x	0.0%
Signature Bank	SBNY	\$1,080	O/A	\$35.64	\$1.38	\$1.69	21.1x	0.0%
<b>Average (unweighted)</b>							<b>19.0x</b>	<b>0.5%</b>
<b>S&amp;P 500 Financials Index</b>				<b>\$411.59</b>				
<b>S&amp;P 500 Index</b>				<b>\$1,412.90</b>	<b>\$91.57</b>	<b>\$100.00</b>	<b>14.1x</b>	<b>1.8%</b>

**Financial Services Group Best Stock Picks for the Next Three to Five Years**

Company	Ticker	12/5/07 Market Cap	Rating/ Profile	12/5/07 Price	2007E EPS	2008E EPS	2008E P/E	Div. Yield
American International Group	AIG	\$141,908	O/C	\$58.15	\$6.23	\$6.60	8.8x	1.4%
Goldman Sachs	GS	\$90,451	O/C	\$218.26	\$24.14	\$22.40	9.7x	0.6%
CME Group	CME	\$34,740	O/C	\$697.25	\$14.50	\$17.85	39.1x	0.5%
Northern Trust	NTRS	\$17,690	O/C	\$79.28	\$3.62	\$4.02	19.7x	1.2%
T. Rowe Price	TROW	\$15,843	O/C	\$62.41	\$2.37	\$2.85	21.9x	1.1%
Affiliated Managers Group	AMG	\$3,674	O/C	\$126.50	\$6.85	\$8.10	15.6x	0.0%
Ambac Financial	ABK	\$2,388	O/C	\$23.52	NA	NA	NA	3.6%
PrivateBancorp <sup>1</sup>	PVTB	\$850	R	\$30.94	\$1.13	\$1.07	28.9x	0.6%
<b>Average (unweighted)</b>							<b>18.0x</b>	<b>1.1%</b>
<b>S&amp;P 500 Financials Index</b>				<b>\$411.59</b>				
<b>S&amp;P 500 Index</b>				<b>\$1,412.90</b>	<b>\$91.57</b>	<b>\$100.05</b>	<b>14.1x</b>	<b>1.8%</b>

<sup>1</sup>Estimates reflect First Call consensus.

Source: FactSet, William Blair & Company, L.L.C. estimates.

The following sections provide a brief update of our expectations for each segment of our financial services coverage group and top picks for our 2008 one-year list if applicable.

**Asset Management****Overview**

Asset management stocks posted another year of solid performance in 2007 (the group we track is up nearly 18% year-to-date), marking the fifth consecutive year of outperformance for the group. On average, gains were driven by 20%-plus earnings growth, offset by modest compression in P/E multiples generally (25% to 30% premium to the S&P 500 last year versus current premium of about 20%). Newly public alternative asset managers (including private equity and hedge fund managers) fared less favorably, down about 15% on average since their respective offerings. The funding environment, volatile financial markets, and some concerns regarding taxation have weighed on the shares of alternative managers—however, we believe strong secular drivers will continue to stimulate long-term growth rates for alternatives in excess of those we expect for traditional asset management. Our outlook for the industry continues to be constructive, as we believe there are ample opportunities for continued growth. Key growth drivers remain: pension reform and demographic trends in the retirement market, the relaxation of investment constraints and increased convergence (including M&A activity) between traditional and alternative asset management, and the accelerating globalization of the business. That said, we continue to emphasize a selective stance in our stock recommendations (and focus on companies we believe can deliver strong relative earnings growth), given continued financial market volatility, five consecutive years of positive returns for global equity markets, and five consecutive years of outperformance for the group.

In 2007 domestic equity indexes produced modest returns, with large-cap equities outperforming small caps. From a U.S.-based investors' perspective, international equity markets (bolstered by emerging markets and currency) appreciated by double-digit rates and outperformed domestic markets for the sixth consecutive year. In addition, after an unprecedented period of underperformance, U.S. growth equities regained market leadership and outperformed value across the market cap spectrum (driven in part by the performance differential between Technology and Financials). Lastly, despite well-publicized issues with leveraged long/short hedge funds over the summer, we believe hedge funds in aggregate posted slightly better investment results relative to the average diversified equity mutual fund in 2007, with outperformance in the low single digits on average.

Mutual fund flows broadened modestly; however, international funds continued to capture greater than 80% of all equity fund flows and passive vehicles (ETFs and index funds) garnered nearly 50% of

equity fund flows—an increase from about 40% in 2006. Growth mutual funds gained momentum after July but were still in a net outflow position year-to-date through October. Value mutual funds experienced outflows for the first time in six years after a strong showing in the first half of 2007. Asset allocation products continued to garner assets at an accelerated clip following last year's pension reform, which approved lifecycle funds as the default option for defined contribution plans (as well as auto enrollment and auto escalation). We view these funds as a significant development that enhances traditional asset managers' abilities to package basic investment advice and retain client AUM in the consolidation and distribution phases—we anticipate these products evolving (including a focus on capital preservation and guarantees). The convergence between alternative and traditional asset management is another important development that we expect will maintain strong momentum, given the vast proliferation of 130/30 and other short extension funds that relax constraints on long-only managers. We believe these and other "alternative strategies" (including hedge funds and private equity) should continue to gain share, given investor demand for absolute return vehicles and strategies that can deliver attractive risk adjusted returns with lower volatility and a low correlation to equity markets. In fact, we anticipate these trends will accelerate, given the residual impact from recent volatility, and believe the separation of alpha and beta and the elimination of investment constraints will gain additional steam in the intermediate term, as it did following the market downturn from 2000 to 2002.

Deal activity (including initial public offerings, listings on private exchanges, and acquisitions by both financial and strategic buyers) increased across nearly all segments of asset management in 2007. Fortress Investment Group (FIG \$18.09) was the first alternative firm to go public and Blackstone (BX \$21.93) was quick to follow. Pure hedge fund managers Och-Ziff Capital Management (OZM \$26.11) and GLG Partners (GLG \$13.85) became public companies in November, preceded by traditional value manager Pzena Investments (PZN \$12.75), which made its debut in October. Other notable transactions included the Madison Dearborn Partners purchase of Nuveen Investments (the largest asset management MBO in history), Power Financial's acquisition of Putnam Investments, BlackRock's purchase of fund-of-funds manager Quellos, Marsico's management buyout from Bank of America, and AMG's recent investments in Cooke & Bieler and ValueAct Capital. We expect select acquisition activity to continue in 2008 as well as additional IPOs with more stable equity markets, despite lackluster performance of recent deals (predominantly alternative managers). We view the convergence of traditional and alternative investment strategies (which may stimulate large private equity firms to acquire traditional managers to enhance recurring revenue), as well as the continuing globalization of the industry (including both investment strategies and distribution capabilities), as major forces fueling additional deals. In addition, given above-average valuation levels, we believe divestitures may also drive M&A, as sellers struggle with mediocre investment performance, distribution conflicts, and/or lack of scale.

Asset management stocks have outperformed for five consecutive years on the strength of strong inflows and generally strong global financial markets. Valuation levels for traditional asset management firms (the focus of our current research coverage) remain at about a 20% premium to the S&P 500 based off of 2008 P/E multiples (in line with the group's five-year average and below its three-year average premium of about 25%). We believe the group has benefited from greater diversification (by AUM and distribution channel) relative to past periods of market uncertainty and a flight to quality, given the attractive economics of the business and its level of transparency relative to other financials. That said, we believe global equity markets have to generate reasonable returns in 2008 for the group to outperform again over the next 12 months. We continue to recommend more selective stock exposure to the space and focus on firms we believe can deliver strong relative results (both organic and earnings growth).

#### **Stock Selection – Affiliated Managers Group**

AMG remains a high conviction, core growth name for us, and we continue to believe it is one of the most attractive growth companies in asset management. We believe cash EPS can increase at 15% to 20% per year for the next three to five years, given normal market appreciation (6% to 8% annually), positive net flows, and acquisitions. Importantly, we believe AMG has the potential to deliver this kind of growth through a full market cycle, given its diversified base of high-quality affiliates, its growing

base of performance fee generating AUM, and increasing opportunities to complete new (and possibly larger) deals.

First, we view AMG as among the most diversified equity managers in its peer group, with more than 300 products from 26 affiliates (includes five firms under First Asset Management) representing some of the top small to midsize boutique managers in the world. The company boasts among the highest allocations to international equities (35% of EBITDA) and alternatives (greater than 15% of EBITDA), which are the two fastest-growing and highest-margin segments of the asset management business. Domestic equities are also well balanced by style, including 30% in U.S. growth (with excellent performance at such firms as Friess Associates) and 15% in value. Second, the company's performance fee opportunity is significant, in our opinion, as performance-fee-generating AUM now exceed \$40 billion and continue to grow. We estimate AMG owns a 25% to 30% stake in performance fees generated by more than 10 affiliates (across nearly two dozen different strategies), and we believe roughly half of these assets are measured on an absolute basis (hurdle rate of zero). Third, the quality of AMG's deal pipeline is as strong as ever, and we believe AMG will remain very active on the deal front. We would not be surprised to see additional transactions focused on either alternative investment firms or international asset managers in the near term. We believe AMG's successful track record and reputation as an innovative partner to its high-quality affiliates uniquely position it to capitalize on its recent momentum, and we believe that larger deals (price tags closer to \$1 billion) are a real possibility. We estimate AMG has invested \$370 million year-to-date and (combined with its recently amended credit facility) maintains at least an additional \$1 billion in investment capacity.

We view valuation for AMG shares as reasonable given the growth characteristics of business and the upside potential from both additional accretive deals (not included in estimates) and performance fees (relatively conservative assumptions, in our judgment). The shares trade at about a 10% discount to the asset management peer group (versus three-year average discount of 20%) based on our 2008 cash EPS estimate for AMG and GAAP estimates for the peer group—that said, estimates for both AMG and the peer group are likely to be reduced modestly, given market performance quarter-to-date. We estimate the shares trade at about a 15% premium, compared with the peer group based on enterprise value-to-EBITDA based on a run-rate of the most recent quarter (including adjustments for noncash taxes) and a 20% to 25% premium on an "if-converted" basis incorporating the full dilution from the impact of contingent convertibles.

## **Brokerage/Investment Banks**

### **Overview**

We see a more challenging environment heading into 2008, given a slowing economy, shaken confidence levels, tighter credit conditions, rising credit losses, and higher market volatility. Near-term earnings visibility is somewhat limited, as November 2007 was one of the most difficult months for trading in recent history and traders and clients have reduced risk levels prior to year-end.

The issues in the subprime RMBS mortgage and broader credits market have adversely affected most major investment banking businesses, but the fixed income business in particular. The trading environment has been more challenging, and segments such as structured credit and leveraged finance have been particularly hard. Major losses have been driven by write-downs of leveraged loan commitments, write-downs of direct subprime and CDO residual positions, and poor hedging strategies. While major losses have already been taken by several major investment banks, heightened volatility makes it difficult to forecast any further damage. Certain businesses have benefited or have not been affected as much by increased market volatility, including the equity and equity derivatives agency business, foreign exchange, government bonds, and commodities. Overseas markets have also held up relatively well so far, helping support better results at more diversified firms. While announced M&A is up modestly year-to-date a dialogue remains active, M&A pipelines overall have declined from cyclical peaks achieved earlier in 2007, given changes in credit markets and increased volatility.

Long-term growth opportunities remain compelling in Asia, derivatives (over cash markets), and alternative investments, and we are very bullish on the development of global capital markets over the

long term. We also believe that the major disruptions in structured credit markets will not affect the growth of the derivatives market over the long term. We continue to see huge growth opportunities in certain derivative product categories, particularly equities and credit.

We have been selective in the space over the past 12 months, given concerns about a cyclical slowdown and the potential for a retreat from cyclical peak profitability achieved in fiscal 2006. While investment bank price-to-book multiples have compressed meaningfully with significant underperformance in the group in 2007, we remain selective in the near term, given low visibility, concerns about continued adjustments in business conditions to more volatile markets in the near term, and concerns about a near-term slowdown in activity outside of the United States.

## **Commercial Banks**

### **Overview**

The current backdrop facing the commercial banking segment is challenging (deteriorating mortgage banking market and rising credit costs). As a result, banks have underperformed significantly thus far in 2007; the bank index has declined 19%, compared to a 4% increase in the S&P 500. Regional bank multiples have contracted, trading at a 25% discount to the S&P 500, compared to a 10% discount one year ago. The regional bank group has underperformed the broader equity markets since the beginning of 2004.

Net interest margins remained under pressure throughout 2007, as the yield curve was inverted until August. The improvement in the shape of the yield curve (the 10-year Treasury yield is roughly 60 basis points more than the 6-month T-bill yield) should ease pressure on net interest margins in 2008. The interest rate environment has a significant impact on the commercial banks because net interest income represents roughly 60% of total revenue. Despite a modestly improved outlook for net interest margins in 2008, EPS growth will remain challenging as credit costs continue to rise.

The credit environment normalized/deteriorated quickly in 2007, exacerbated by disruption in the mortgage banking market. The slumping housing market has led to acceleration in nonperforming loans not only in consumer-related loans, but also in the builder and developer segments of the commercial lending market. We expect credit costs to continue to rise across the segment, and believe the extent of credit quality deterioration remains uncertain.

With more than 7,300 commercial banks across the U.S., the industry continues to be ripe for M&A activity. Consolidation has been relatively modest this year, in our opinion, with 250 bank and thrift deals announced thus far, compared to 277 in 2006 and an average of 295 per year over the last 15 years. We expect consolidation activity to increase in 2008 as a result of the difficult operating environment. Thus far in 2007, the average price per deal was 20.5 times forward EPS and 2.4 times book, compared to 16 times forward EPS and 2.1 times book five years ago.

### **Stock Selection – Signature Bank**

Our top stock selection in commercial banking is Signature Bank. We expect robust EPS growth to produce strong stock performance over the next 12 months. We believe better-than-peer EPS growth will be driven by Signature's ability to capture market share from its larger bank peers via attracting veteran bankers, by improving its earning asset mix, and by realizing relatively modest credit costs.

The company is building on its reputation as the bank of choice among seasoned relationship bankers—the bank has added 14 group directors in 2007, an increase of 24% on the year. Experienced bankers are increasingly attracted to Signature as a result of its entrepreneurial culture, lean organization structure, and attractive incentive-based compensation model.

Signature has an opportunity to expand its net interest margin as loans become a larger percentage of earning assets. Loans represent only 36% of average interest earning assets, up from 30% one year ago; loans carry a higher yield than the investment securities they are replacing.

The company has less exposure to deteriorating credit quality than its bank peers, as loans represent only 36% of interest earning assets, and its loan portfolio has not fully matured.

We believe Signature Bank's shares deserve to trade at a premium to its peers, as a result of its superior growth prospects. We expect the company to increase its EPS at a compound annual rate of 20% over the next five years (22% in 2008 and 2009), versus its peer group average of 12%. Its shares trade at 21 times our 2008 EPS, compared to 13 times on average for its closest peers.

## **Exchanges**

### **Overview**

The exchange industry continued its development in 2007 as one of the most dynamic within financial services. We expect volume growth to continue to benefit from higher financial market and commodity price volatility, and exchange-listed markets also tend to be seen as more attractive during periods of uncertainty, given high transparency and the credit integrity of centralized clearing. The combination of strong volume growth, attractive financial characteristics, and continued consolidation were the main drivers of continued superior outperformance in 2007.

While volume growth has been rapid over the past few years, we see many of the major growth drivers still developing, including electronification, the continued development of the alternative investment space, globalization, deregulation, and the increased understanding of the benefits of risk management. Importantly, we expect consolidation to continue after a very active 2006 and 2007. We view ICE and NYMEX as the most visible targets and Deutsche Boerse, NYSE Euronext, and CME Group as the top global consolidators. We also expect more business relationships to develop between U.S. and other international exchanges.

Our research continues to focus on the futures exchanges, given that we believe these are more attractive business models than cash equities/equity derivatives exchanges, due to the lack of fungibility—creating barriers to entry, better pricing flexibility, and higher margins. Futures trading is also less expensive than related cash markets. Not only do we see further organic growth opportunities within the futures exchange business, but there are huge opportunities for growth and expansion into the other-the-counter (OTC) markets, including foreign exchange, interest rate swaps, and credit derivatives. The OTC derivatives markets are about 6 times larger than exchange-traded derivatives markets. We view the potential for the electronification of the OTC markets, the desire of market participants to increase transparency, and need to limit bilateral credit exposures as potential catalysts for further exchange participation in the growth of OTC markets by the futures exchanges.

Valuations for the exchange space remain rich, but the exchanges represent a dominant business model and the financial profile of the exchanges is likely to remain attractive with higher financial market volatility and credit concerns. The key concern is the sustainability of volume growth in context of current valuation; with a reduction in volatility the greatest near-term risk and obviously difficult to predict. Changes in regulation are the major fundamental risk for the futures industry, but with the recent clean approval of the CME/CBOT merger in mid-2007 we believe this risk has been reduced in the near term.

### **Stock Selection – CME Group**

We view CME as the core name within the exchange space. It is the largest and most diversified futures exchanges—interest rates (64%), equities (25%), foreign exchange (5%), and commodity and alternative investments (6%); about 80% of its volume is traded electronically.

We also view CME as having favorable financial characteristics within volatile markets—volumes benefit from higher financial market volatility, the company has minimal credit risk, and exchange listed derivatives are even more attractive in volatile markets, given increased transparency and the elimination of counterparty credit risk through centralized clearing. While continued higher volatility is the key to further strong volume growth, we also have increasing confidence that the company will capture revenue synergies once it moves the CBOT's U.S. Treasury complex onto the CME's Globex electronic trading platform (late January). Globex is faster and more reliable than the CBOT's

electronic platform, which should drive more algorithmic trading. We also believe spread or yield curve trading between the short end and the longer end of the curve will be greatly enhanced by having all products on the same platform.

After the company more fully digests the CBOT acquisition, the CME Group should continue to be acquisitive, which we view positively. The most obvious product gaps are energy and credit, and we believe the company will continue to seek partnerships/joint ventures overseas, similar to recent announcements with the Korea Exchange and the Brazilian Mercantile and Futures Exchange. It is uncertain whether the company would make a large acquisition outside of the futures industry, such as the equity derivatives industry or the interdealer OTC brokerage business.

Valuation is rich at 39 times our 2008 EPS estimate, but our estimate is too low if volatility continues at recent levels. We view the stock as a hedge against higher financial market volatility in the near term. Our key near-term concern is a sudden drop in volatility coupled with the current high valuation.

### **Stock Selection – IntercontinentalExchange**

ICE pioneered the electronic trading of energy futures globally and the electronic trading of OTC energy derivatives in the United States. ICE is among the fastest-growing global exchanges, and we view it as one of the more-dynamic growth companies within financial services. We see the development of electronic energy derivatives trading still developing on a global basis, particularly within the OTC markets, and ICE is proving its ability to extend its franchise beyond energy markets, in our opinion. The company's revenue is split 42% OTC electronic energy trading, 37% electronic energy futures, and 21% soft-commodities.

Similar to the CME, we view ICE as having favorable financial characteristics within volatile markets. The company is a beneficiary of continued energy price volatility and also has minimal credit risk. Although we expect ICE to continue to make smaller accretive acquisitions and potentially a larger transforming transaction, we view ICE as an attractive takeover candidate on its own, with the CME Group, Deutsche Boerse, and NYSE Euronext as the most logical buyers.

In 2007, ICE paid \$50 million to gain exclusive rights to market futures on the Russell indices—taking this exclusivity from the CME Group. It was an aggressive move and given the challenges of building liquidity in a new futures product from scratch we have not included any benefits from the Russell agreement in our estimate. While liquidity is the most important factor in attracting liquidity, thus creating a “Catch 22” for any new product, we believe the Russell brand could be potentially successful in supporting the creation of a new liquidity pool.

One of ICE's largest near-term opportunities and one of its greatest risks is the company's move to self-clearing beginning on July 1, 2008. In 2006, ICE customers paid about \$50 million in clearing fees to LCH.Clearnet in order to trade ICE products. However, ICE is one of LCH's largest customers, and LCH cut prices aggressively to create some tension between ICE's customers and ICE in an effort to keep this business. There has also been a lot of speculation in the market fueled by other futures market participants—including certain brokers and exchanges—that ICE's move to self-clearing coupled with the adoption of MiFID could open the company's European futures franchise to competition. Given that ICE's technology is first class, customers are directly connected to both its futures and OTC platforms, and liquidity is by and far the dominant driver of the cost of trading, we believe there is little risk of ICE's franchise being damaged in the near term by its move to self-clearing.

Valuation is rich at 36 times our 2008 EPS estimate, but ICE can increase EPS in excess of 30% in 2008, its financial characteristics are attractive in volatile markets, and a potential acquisition provides some valuation support. Our key near-term concerns are a sudden drop in energy price volatility coupled with high valuation and the execution risk associated with the move to self-clearing.

## Financial Guaranty

### Overview

Financial guaranty remains the most out-of-favor sector in our coverage universe, as the integrity of the industry has come into question, given the continued deterioration in the subprime RMBS market, the industry's large absolute exposure to the subprime RMBS market, and a dramatic negative turn in sentiment toward the entire space. We see no major structural changes coming for the industry, but the rating agencies are clearly concerned about the capital adequacy supporting the industry's subprime RMBS exposure—principally multisector CDOs and to a lesser extent HELOCs. We believe customers/distributors within the municipal finance market will regain confidence in certain guarantors once the capital issues are addressed in the near term.

Updated capital adequacy analysis from each of the three major rating agencies will drive near-term capital needs (prior to year end) for five of the seven triple-A monoline guarantors—Ambac, CIFG (capital raising intentions already announced) FGIC, MBIA (MBI \$30.00), and Security Capital (SCA \$6.86). All of these competitors made grave errors in becoming more aggressive in the multisector CDO segment too soon, in our opinion, particularly Security Capital. We expect that all five of these companies will need to raise capital in some form, the first option being the use of additional reinsurance and the last option being straight common equity. Quantifying near-term capital needs and therefore identifying fundamental value within the group is a challenge, given the difficulty in handicapping the potential severity of the downturn in the U.S. mortgage market. Monthly remittance data on RMBS transactions and macroeconomic data will be scrutinized closely over the next several months in an attempt to find the bottom of a challenging housing downturn, and it is too early to assess the efficacy of any government-supported efforts to mitigate future default levels, in our opinion. The only publicly traded financial guaranty company that has a quantifiable exposure to the RMBS market is Assured Guaranty, given no exposure to multisector CDOs from recent years, in our opinion.

On the positive side, given the widening in credit spreads and higher demand within the U.S. structured finance market, the new business environment is as good as it has been in the last four years, and those companies not affected by the mortgage malaise (principally Assured Guaranty and FSA) are particularly well positioned to benefit in the near term, in our opinion. Importantly, the financial guaranty business is driven by the development of capital markets globally, which we believe will provide above-average growth opportunities relative to other areas of financial services over the long term. We also believe there is room for consolidation among the seven triple-A-rated monoline companies in the space over time.

Valuation remains at trough valuation levels, and we believe there is plenty of value within the space, as investors have adopted the most draconian scenarios in attempting to quantify the impact on those names with difficult to quantify exposure—Ambac, MBIA, and Security Capital.

### Stock Selection – Assured Guaranty

Assured Guaranty is a Bermuda-based financial guarantor—largest reinsurer and sixth-largest insurer. ACE Limited (ACE \$60.84) still owns an approximate 28% interest. Its insured portfolio as of 9/30/07 was 6% domestic public finance, 65% domestic structured finance, and 29% international. Financial guaranty insurance constitutes about 70% of our 2008 underwriting income estimate.

Assured Guaranty was upgraded to triple-A by Moody's in mid-July and has the only quantifiable subprime RMBS loss exposure among its publicly traded financial guarantor peers, given its smart decision to not guarantee multisector CDOs over the past few years. Not only did Assured Guaranty refuse to guarantee these products within its insurance operations, the company also excluded multisector CDOs from its reinsurance treaties starting in 2004, highlighting smarter credit decision-making than most of its major competitors—Ambac, CIFG, FGIC, MBIA, and Security Capital. The key mortgage-related exposure that is of any serious concern is the company's \$2.5 billion exposure to HELOCs, although potential losses here are more quantifiable than within the multisector CDO segment.

Given its upgrade to triple-A, an excess capital position, and an enhanced position in the market due to a lack of RMBS concerns, Assured Guaranty's new business opportunities and returns should continue to expand nicely over the next few years—particularly in the lower-risk U.S. public finance market. The company's new business pipeline at the end of third quarter 2007 was about triple the size of its new business pipeline 12 months earlier, and the company has taken share from other companies recently suffering from mortgage woes. Amazingly, the company captured 8% market share within the U.S. public finance market in October and November, compared to 0% in the past, given the rating concerns at its major competitors. Margins should also improve over time, given the benefits from increasing scale; the company's expense ratio within financial guaranty was 59% in 2006, more than double the market leaders.

AGO shares trade at an 8% discount to book value per share excluding other comprehensive income and the cumulative negative mark to market on the credit derivatives portfolio. Although this valuation level is now by far the highest among its peer group and there may not be as much upside relative to other names in the space, visibility is much higher and absolute valuation remains low, allowing room for healthy appreciation on an absolute basis, as concerns about the mortgage market dissipate. We believe the key near-term risk is a recession or if any of the three major rating agencies panic and change their view on the integrity of the financial guaranty business generally.

## **Insurance – Commercial Property-Casualty and Life**

### **Commercial Property-Casualty Insurance Overview**

In 2007, commercial property-casualty insurance stocks outperformed the financial services group overall, given strong earnings growth, the defensiveness of the group, and the lack of any direct exposure to the subprime RMBS market or credit markets in general. That said, the overall performance of the space in general was sluggish on an absolute basis, held back due to broad concerns about increasing price competition. As a result, valuation levels have regressed closer to average historical multiple levels, and we continue to see more value in the large-cap underwriters. Insurance brokerage valuation levels are above average from a historical perspective, as that segment has benefited from its defensive characteristics.

In 2008, we expect further pressure on pricing and premium growth, after record underwriting margins in 2006 and 2007. In 2008, earnings visibility should remain relatively high, supported by continued benign claims inflation and favorable loss reserve development for business written between 2003 and 2005 (e.g., releasing reserves from business written in the past that boosts current earnings). That said, underlying margins continue to deteriorate, which could create significant earnings pressure by 2009—similar to the dynamic that has taken place in the personal auto insurance business over the last 12 to 18 months. The industry's inability to remain disciplined over any reasonable period of time is well documented; we are concerned about the deterioration underlying underwriting margins. We believe it will take some pain before the market capitulates and presses for higher prices.

We expect consolidation to continue, after an expected pickup in activity in 2007 as larger companies reach for growth and diversification. Lower valuation levels also support a pickup in consolidation activity. In 2007, nine publicly traded insurance underwriters (including personal lines) were acquired (including announced transactions) and two publicly traded insurance brokers were acquired, the latter driven by private equity buyers. The valuation levels for the takeovers in 2007 on a price-to-book value per share (most recent value) basis were relatively full, in our opinion—21st Century at 1.9 times, Alfa at 2.0 times, Bristol West at 1.85 times, Commerce Group at 2.0 times, Direct General at 1.65 times, Midland at 2.0 times, Ohio Casualty at 1.7 times, PXRE Group at 0.85 times, and SCPIE Holdings at 1.2 times. For the insurance brokers, Hub Group was purchased for about 12 times EV-to-2006 EBITDA, and USI was purchased for 10 to 11 times EV-to-2006 EBITDA. There was just one acquisition of a publicly traded insurance underwriter that closed in 2006—Republic Group at 1.7 times.

Given concerns about the deterioration in the underlying profitability of the business, we are cautious in general regarding this group, although the group's defensive characteristics could be attractive (including minimal subprime RMBS exposure) in a difficult environment for financial services stocks.

The industry is also very large and fragmented, and therefore we see some “special situations” as attractive

### **Stock Selection – Argo Group**

Argo is a Bermuda-based specialty commercial lines property-casualty insurer; 2008 estimated net written premiums: 55% excess-and-surplus lines, 35% specialty commercial, and 10% international specialty (roughly 20% property exposure). We view Argo as an emerging excess-and-surplus lines and specialty underwriting franchise.

Argonaut Group and PXRE merged in July 2007 to form Argo Group International. We believe the PXRE merger represents a major positive strategic development. The transaction provides the former Argonaut Group with a more flexible Bermuda-based operating platform, a larger balance sheet that allows more risk retention, and the acquisition of significant excess capital that improves financial flexibility dramatically.

However, in the near term the merger has put pressure on the stock, given that the deal is ROE dilutive and management has not done a very good job of even coming close to quantifying the positive impact of the transaction. This fact has been exacerbated by the loss of Argonaut Group's former chief financial officer, who decided to pursue other career opportunities. Therefore, the key catalyst in driving the stock higher in the next 12 months is management's ability, including the new CFO, to clearly quantify the positive impact from the PXRE merger. We believe the stock can outperform even in the face of deteriorating profitability for the commercial property-casualty insurance industry, and we view the name as extremely defensive if the environment for financial services stocks in the aggregate remains challenging in 2008.

The shares trade at about a 15% discount to book value per share, given the ROE dilution from the PXRE merger. The key risk in the near term is greater-than-expected price competition and management's unwillingness or inability to quantify the benefits from the merger or the use of its excess capital.

### **Life Insurance Overview**

We remain opportunistic and selective within the life insurance space overall within our coverage universe, given limited growth opportunities for the group overall and a lack of volatility in fundamentals. In 2007, performance in the space held up relatively well as the group benefited from its defensive characteristics and strong performance from a few large-capitalization stocks.

The competitive and investment environment for life insurers remains challenging, in our view, although the latter should benefit from the recent steepening of the yield curve over time. Higher short-term interest rates and a flattish/inverted yield curve over the past few years have been putting pressure on investment spreads, as well as sales, given greater competition from alternatives to fixed annuities like CDs. The variable annuity business stabilized in 2007, but overall trends within the business are not overly robust and emerging product features are still driving overall sales (e.g., guaranteed minimum withdrawal benefit). However, we expect ordinary life sales to continue to improve further after capacity was withdrawn in 2006 and early 2007, given legislative concerns about premium finance life sales

Increase credit and legislative risks are likely to garner even more attention during 2008. Life insurers take on more credit risk than property-casualty insurers, given the need to generate adequate investment spreads, and therefore further deterioration in the credit environment could put modest pressure on capital levels in the near term. Legislative changes are always a risk for the industry, although we do not expect any major legislative challenges this year, given the changing political landscape. The estate tax repeal is no longer a near-term issue, given recent changes in Congress and the potential for Democratic presidency

Unlike property-casualty insurance, we do not expect an acceleration in consolidation activity, but we do expect select activity to continue as competitors reassess their long-term growth opportunities. We view valuation modestly above average, given the respectable performance so far this year.

### **Stock Selection – American International Group**

AIG is the most dominant diversified financial services company focused on insurance in the world, in our opinion, and is the best play within insurance on the continued growth of Asia (about one-third of earnings)—including the continued deregulation of Japan and the growth of major emerging markets, including China, India, and Vietnam. AIG is the largest life insurer serving Southeast Asia.

While AIG's capital management efforts were a little more aggressive in 2007, we view more aggressive capital management as a key catalyst going forward and expect the company to face increasing pressure to unlock the underlying value among its disparate businesses.

We believe the shares are a bit more defensive relative to large-cap banks and/or brokers, given lower earnings sensitivity to changes in equity/capital markets. That said, AIG does have exposure to the residential mortgage market and credit markets more broadly, although we believe its exposure is manageable. The two small businesses that will continue to face earnings pressure from the weak mortgage market include consumer finance and mortgage insurance. The company's investment portfolio and credit enhancement business (AIG Financial Products) have also continued to suffer some mark-to-market losses given deterioration in the market, but we expect it to suffer more manageable economic losses given that AIG holds these positions to maturity and the vast majority of the company's exposure is highly rated with limited exposure to the troubled 2006 and 2007 vintages.

While some headwinds are present, AIG's stock has not been this inexpensive since the early 1990s on an absolute and relative basis, and the company has very valuable assets. On a sum-of-the-parts basis, we arrive at a stock price easily in excess of \$70 using peer group multiples in addition to the 15% growth in book value per share we expect over the next 12 months, excluding other comprehensive income (excludes unrealized gains/losses on investments and FAS No. 133 adjustments)

The key risks include a more conservative stance on capital management, additional pricing pressure within commercial property-casualty underwriting, and the continued drag from more economically sensitive businesses including consumer finance and mortgage insurance, and a lower contribution from partnership investments

### **Stock Selection – National Financial Partners**

NFP is an independent distributor of high-end financial services products: about 55% life insurance and wealth transfer, about 35% corporate and executive benefits, and about 10% financial planning and investment advisory. NFP's strategy is to purchase smaller life insurance and benefits-oriented distributors and enhance their growth opportunities by creating the proper incentives for future growth and bringing the power of a national distributor to the local level. The company is one of the largest distributors of life insurance, with a national distribution network focused on U.S. wealth centers, comprising 180 wholly owned firms, more than 320-plus affiliated firms, and more than 2,200 producers.

We remain highly confident in the durability of NFP's growth prospects, and we believe the company has the ability to increase cash EPS by 15% over the long term through the combination of 6%-10% long-term organic growth, additional acquisitions, operating leverage at the parent company level, and more aggressive capital management. Importantly, we expect near-term organic growth rates to continue to improve in the near term, given improvements in the life insurance sales environment and easier growth comparisons.

We believe NFP's business model and financial characteristics stand out uniquely if the environment for financial services companies remains more challenging. The company has minimal capital requirements as a distributor, is less economically sensitive, it has no direct interest rate or equity market exposure outside its small financial advisory business, and has no credit exposure. In addition, nearly 100% of acquisitions over the past few years have been benefits-oriented firms, which should help drive higher recurring revenue over time.

The stock is down more than 20% from its recent high and now stands now at a 15% discount to the S&P 500, based off of 2008 EPS estimates, which we believe is attractive for a financial company that has the ability to compound cash EPS at 15% without the blowup risk of a typical financial company. The primary issue that NFP has faced recently has been investors' limited tolerance for quarterly organic revenue growth and margin volatility. We estimate that NFP's recurring revenue is approximately 55% and because NFP shares in the earnings of its affiliates, the company does not control expenses at the firm level, thus leaving NFP exposed to quarterly earnings volatility. We believe the failure management has made has been in setting very poor expectations and attempting to predict near-term margin and earnings trends.

## **Securities/Custody Banks**

### **Overview**

We believe the securities/custody banks will continue to produce above-average top-line growth within the financial services industry for the next several years. Global secular trends continue to be favorable and are supported by increased savings levels (aging of population), greater pressure on public pension schemes, and growth in cross-border investing. We believe that increasing complexity of investment strategies and products (derivatives, ETFs, hedge funds, multimanager arrangements) and greater attention to operations infrastructure to support fund administration, performance measurement, recordkeeping, compliance, and risk management should drive more outsourcing opportunities for the custody providers. We believe growth over the next few years will be driven primarily by Europe. However, activity in China, Australia, and the rest of the Pacific Rim region has accelerated recently and is likely to become a larger portion of AUC growth over the next several years.

Revenue can be volatile quarter-to-quarter, due to equity values, fund flows, cross-border flows, foreign-exchange volatility, trading activity, and interest rates. During third quarter 2007, foreign-exchange revenues increased by more than 70% for the custodial banks, as a result of extraordinarily high client volume and currency volatility. While we expect foreign exchange to continue to produce robust growth due to the globalization of investing, we believe comparisons to third quarter 2007 could be difficult as capital markets activity is likely to decelerate.

We expect the Federal Reserve's recent easing of the federal funds rate to be a positive for NTRS and STT as they are liability-sensitive. In addition, the improvement in the shape of the yield curve (the 10-year Treasury yield is roughly 60 basis points more than the 6-month T-bill yield) from an inverted position could provide incremental net interest margin benefits in 2008. That said, the interest rate environment does not impact the custody banks as much as the regional banks, because net interest income represents roughly 20%-25% of total revenue for the custody banks compared to roughly 60% on average for the regional banks.

Relative price-to-equity multiples for the group have increased to a premium of roughly 20% to the overall equity markets, which we believe is justified as a result of positive secular growth trends in the global custody business. The custody banks (+20%) have outperformed the broader equity markets and most other financials thus far in 2007. We believe the custody banks could continue to outperform the regional and money center banks given lower credit risk. As credit costs across the banking industry continue to increase, investors may view the securities banks as a safe haven, given that they are less sensitive to the credit cycle. That said, the group remains sensitive to capital market conditions and tough competition.

## **Specialty Finance – Commercial and Consumer**

### **Commercial Finance Overview**

In recent years, robust economic growth and low credit costs have attracted a significant amount of capital to the specialty middle-market lending segment, causing loan spreads to contract and encouraging borrowers to increase debt multiples (debt-to-EBITDA). However, loan spreads widened in the third quarter and debt levels have contracted over the last couple of months. We view this as a positive, as lender return on investment tends to increase with spreads.

Despite better loan spreads in recent months, the shares of commercial finance companies have declined more than 40% on average thus far in 2007. We attribute the decline to heightened risks associated with commercial finance companies' ability to secure long-term financing, given that they access the capital markets to fund loan growth. The market for asset-backed securities (including CLOs, their primary source of long-term funding) has diminished because of weakness in the mortgage-backed security market and rising expectations for an economic slowdown. Consequently, we believe many institutional investors (including CLO managers) who relied entirely on the securitization market for funding have reduced investment or exited the primary market. On the other hand, we believe commercial finance companies and other specialty lenders with access to alternative sources of financing will survive the crunch, albeit with higher cost of funds.

In terms of the competitive environment, we believe consolidation in the banking industry will continue to curtail banks' appetite for direct middle-market leveraged lending, as they become more focused on larger customers. In addition, banks are traditionally more risk-averse and often avoid direct participation in what they consider to be complicated transactions. That said, we believe money center and regional banks may be more willing to provide financing (essentially private CLOs) to commercial finance companies with proven direct origination capabilities, as they look for alternative opportunities to grow their own balance sheet—we believe banks' appetite for residential mortgage-related assets has waned significantly.

### **Consumer Finance Overview**

Underlying fundamentals have been negatively impacted by deterioration of the residential mortgage market (rising delinquencies and foreclosures, tighter lending standards, and declining home values). As a result, consumer finance companies' shares have declined more than 30% on average in 2007.

Credit trends in consumer finance have deteriorated in 2007, and the pace of delinquencies and charge-offs has accelerated in recent months. We believe that turmoil caused by aggressive mortgage underwriting, particularly in the subprime segment, has started to spill over into other areas of consumer finance, including credit card and auto. We see a more binary consumer, meaning greater pressure at the low end of the credit spectrum (subprime), while the high-end (affluent) consumer has weathered the storm. We expect credit costs to continue to rise across the segment, and believe the extent of consumer credit quality deterioration remains uncertain.

Growth of credit card debt is accelerating, increasing 7.5% at the end of October from one year prior. This compares to annual growth of 6.3% at June 30 and low single digits through the first five months of the year. We believe the accelerated growth rate is a result of lower principle payment rates and fewer available borrowing options (tighter mortgage and home equity markets). In 2008, we believe card growth will stabilize in the mid- to upper-single-digit range as current conditions persist.

Mortgage rates have been volatile due to disruption in the marketplace. The 30-year fixed rate mortgage was 6.21% in November and was higher than that earlier in the year, despite a decline in the 10-year Treasury yield over the same period. Recession fears have caused Treasury prices to rally in a flight-to-safety, sending yields lower since June when the 10-year note stood at 5.03%, compared to 4.00% today.

The spread of the 30-year fixed rate mortgage over the 10-year Treasury is more than 200 basis points, up from an average 150 basis points during the first half of the year. The discrepancy is a result of risk premium attached to new originations as lenders have tightened underwriting standards in the aftermath of a period of aggressive underwriting. We expect the spread to remain relatively high through most of 2008, reducing the potential impact of Fed rate cuts on mortgage origination levels. According to the Mortgage Bankers Association, mortgage originations are expected to be \$2.32 trillion in 2007, a six-year low; originations in 2008 are forecast to be \$1.67 trillion, the lowest since 2000.

Additional information is available upon request.

**Current Rating Distribution (as of 11/30/2007)**

<b>Coverage Universe</b>	<b>Percent</b>	<b>Inv. Banking Relationships*</b>	<b>Percent</b>
Outperform (Buy)	60	Outperform (Buy)	12
Market Perform (Hold)	39	Market Perform (Hold)	6
Underperform (Sell)	1	Underperform (Sell)	1

\*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

Mark Lane attests that 1) all of the views expressed in this research report accurately reflect his/her personal views about any and all of the securities and companies covered by this report, and 2) no part of his/her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed by him/her in this report.

Stock Rating: William Blair & Company, L.L.C. uses a three-point system to rate stocks. Individual ratings reflect the expected performance of the stock relative to the broader market over the next 12 months. The assessment of expected performance is a function of near-term company fundamentals, industry outlook, confidence in earnings estimates, valuation, and other factors. Outperform (O) – stock expected to outperform the broader market over the next 12 months; Market Perform (M) – stock expected to perform approximately in line with the broader market over the next 12 months; Underperform (U) – stock expected to underperform the broader market over the next 12 months; Not Rated (NR) – the stock is currently not rated.

Company Profile: The William Blair research philosophy is focused on quality growth companies. Growth companies by their nature tend to be more volatile than the overall stock market. Company profile is a fundamental assessment, over a longer-term horizon, of the business risk of the company relative to the broader William Blair universe. Factors assessed include: 1) durability and strength of franchise (management strength and track record, market leadership, distinctive capabilities); 2) financial profile (earnings growth rate/consistency, cash flow generation, return on investment, balance sheet, accounting); 3) other factors such as sector or industry conditions, economic environment, confidence in long-term growth prospects, etc. Established Growth (E) – Fundamental risk is lower relative to the broader William Blair universe; Core Growth (C) – Fundamental risk is approximately in line with the broader William Blair universe; Aggressive Growth (A) – Fundamental risk is higher relative to the broader William Blair universe.

The ratings and company profile assessments reflect the opinion of the individual analyst and are subject to change at any time.

The compensation of the research analyst is based on a variety of factors, including performance of his or her stock recommendations; contributions to all of the firm's departments, including asset management, corporate finance, institutional sales, and retail brokerage; firm profitability; and competitive factors.

THIS IS NOT IN ANY SENSE A SOLICITATION OR OFFER OF THE PURCHASE OR SALE OF SECURITIES. THE FACTUAL STATEMENTS HEREIN HAVE BEEN TAKEN FROM SOURCES WE BELIEVE TO BE RELIABLE, BUT SUCH STATEMENTS ARE MADE WITHOUT ANY REPRESENTATION AS TO ACCURACY OR COMPLETENESS OR OTHERWISE. OPINIONS EXPRESSED ARE OUR OWN UNLESS OTHERWISE STATED. FROM TIME TO TIME, WILLIAM BLAIR & COMPANY, L.L.C. OR ITS AFFILIATES MAY BUY AND SELL THE SECURITIES REFERRED TO HEREIN, MAY MAKE A MARKET THEREIN AND MAY HAVE A LONG OR SHORT POSITION THEREIN. PRICES SHOWN ARE APPROXIMATE. THIS MATERIAL HAS BEEN APPROVED FOR DISTRIBUTION IN THE UNITED KINGDOM BY WILLIAM BLAIR INTERNATIONAL, LIMITED, REGULATED BY THE FINANCIAL SERVICES AUTHORITY (FSA), AND IS DIRECTED AT, AND IS ONLY MADE AVAILABLE TO, AUTHORIZED PERSONS AND OTHER PERSONS FALLING WITHIN COB 3.2.5(1)(b) OF THE FSA HANDBOOK, AND MAY NOT BE PASSED ON TO PRIVATE CUSTOMERS IN THE UNITED KINGDOM. ANY UNAUTHORIZED USE IS PROHIBITED. "WILLIAM BLAIR & COMPANY" AND "WILLIAM BLAIR & COMPANY (SCRIPT)" ARE REGISTERED TRADEMARKS OF WILLIAM BLAIR & COMPANY, L.L.C. Copyright 2007, William Blair & Company, L.L.C.

*William Blair & Company®*

Investment Banking ▪ Asset Management ▪ Equity Research ▪ Institutional & Private Brokerage ▪ Private Capital

William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 [www.williamblair.com](http://www.williamblair.com)

CHICAGO BOSTON LONDON NEWYORK SAN FRANCISCO SHANGHAI TOKYO ZURICH