Investment Strategy Report
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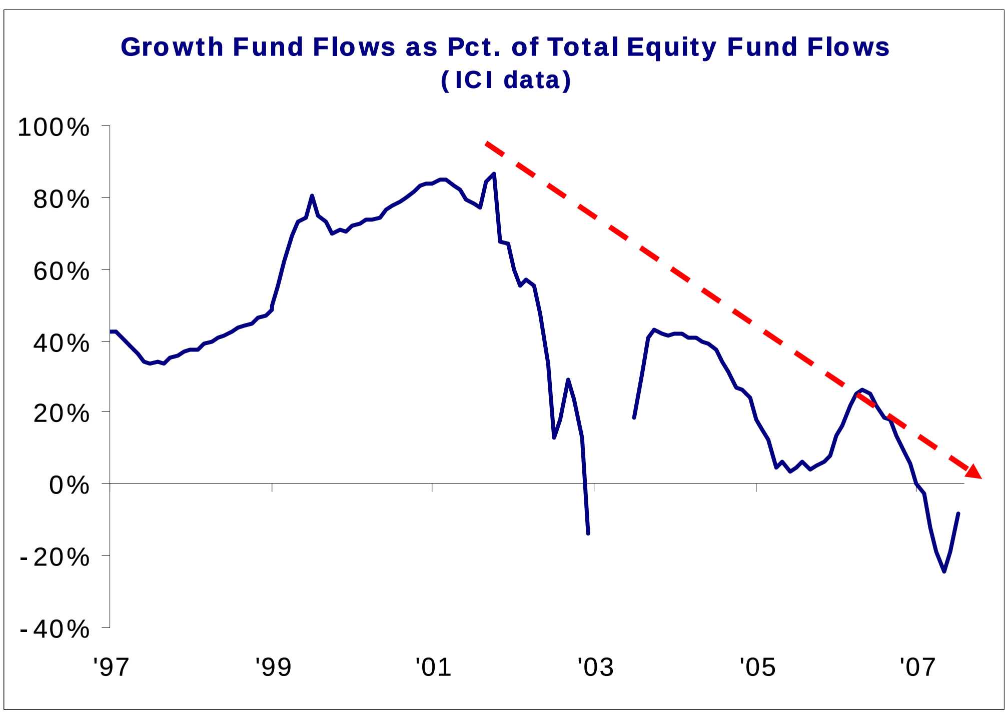
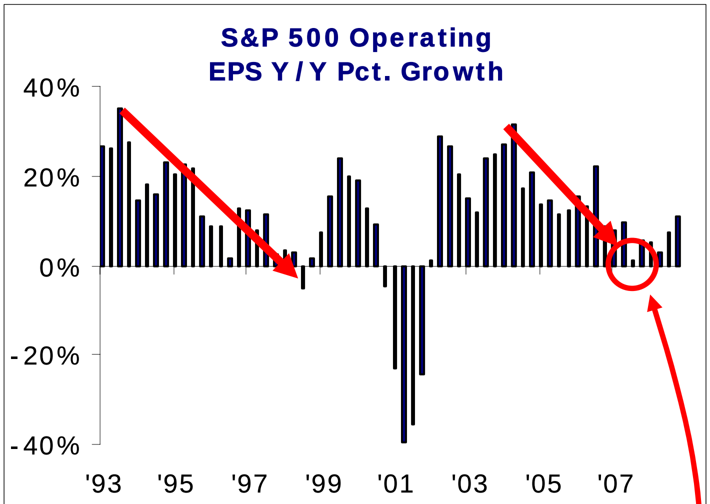
IS THE LARGE-CAP GROWTH STORY REALLY CONSENSUS?

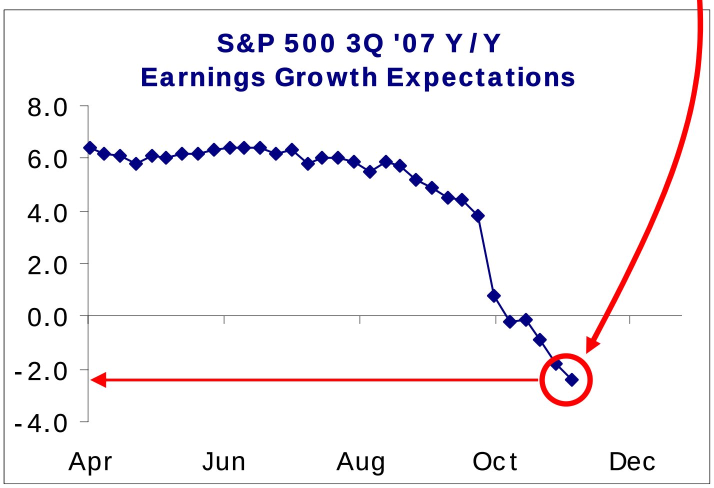
More than one client has described our proposed overweight in large-cap growth as "consensus," pointing out that most sell-side strategists have the same call. While it's hard to argue that many of our colleagues are indeed suggesting that investors leg into large-cap growth stocks, we think it's important to remember that fund flows indicate that this view is far from consensus among investors. As a matter of fact, there have been net redemptions of more than -$10.3 billion from growth and aggressive growth in the last 12 months, compared with net inflows of about +$130 billion into all equity funds. We continue to believe that growth stocks will become more attractive as both economic and earnings growth become more scarce. In this regard, the estimated -2.4% decline in S&P Operating earnings in 3Q may be the biggest marginal change in the investment landscape in the past five years. An economic slowdown without a recession favors growth stocks.



TO DATE, EARNINGS PROFILE CHARTING SAME COURSE AS LAST BUSINESS CYCLE…

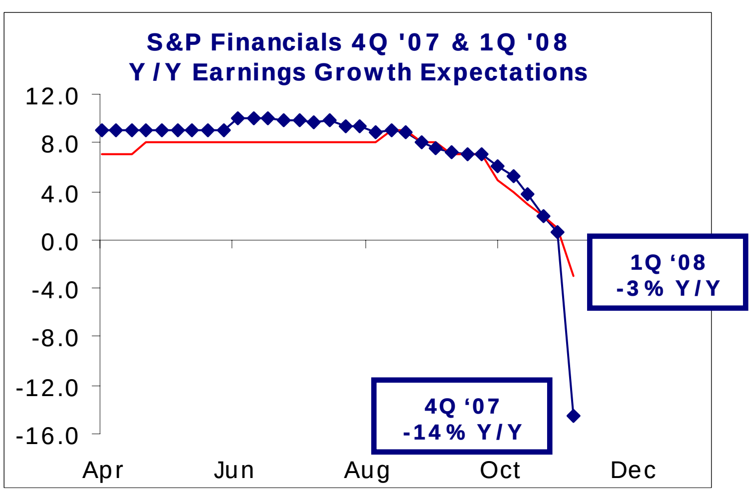


In the 1990s earnings *growth* peaked in 3Q '93 at +35.1% Y/Y and then while the *level* of corporate profits continued higher through the balance of the decade, the rate of growth declined until 3Q '98 (the quarter of LTCM) when it went just slightly negative.



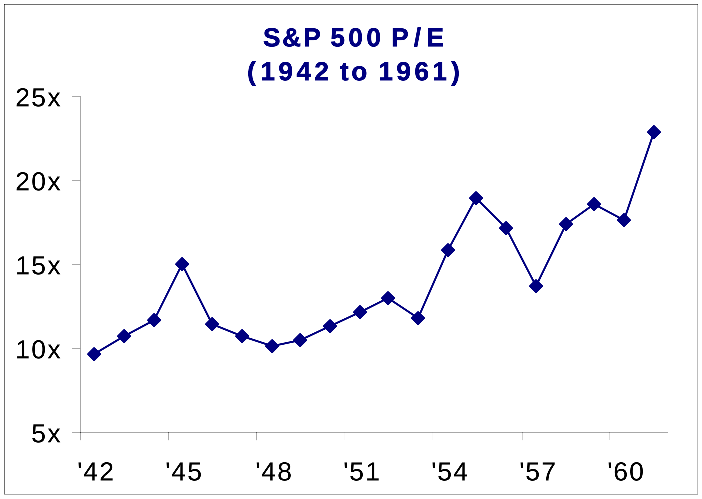
This decade, a similar profile has developed. While earnings *growth* peaked in 4Q '04 at +31.4% Y/Y, the *level* of corporate profits has continued to move higher. With roughly 90 pct. of the Index reporting, profit growth for 3Q stands at -2.4% Y/Y, just slightly negative.

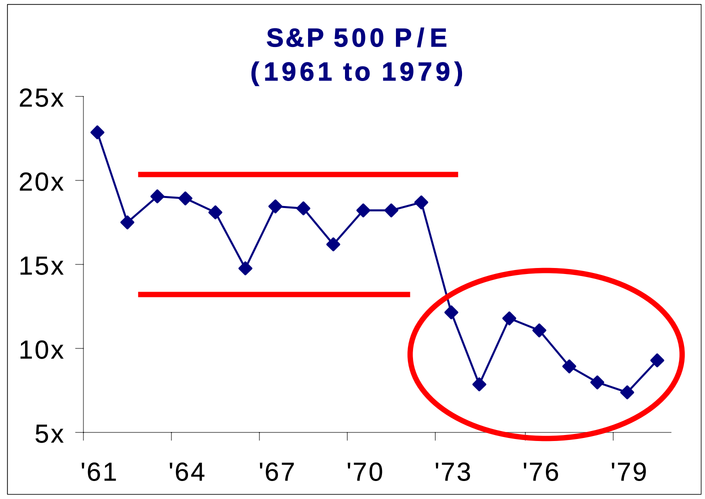
…HOWEVER, PROFIT GROWTH "RECOVERY" MAY NOT BE AS STRONG AS LATE-'90s

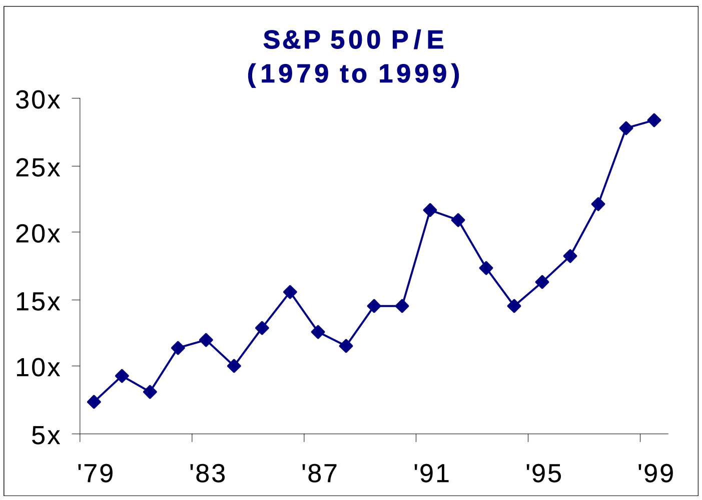


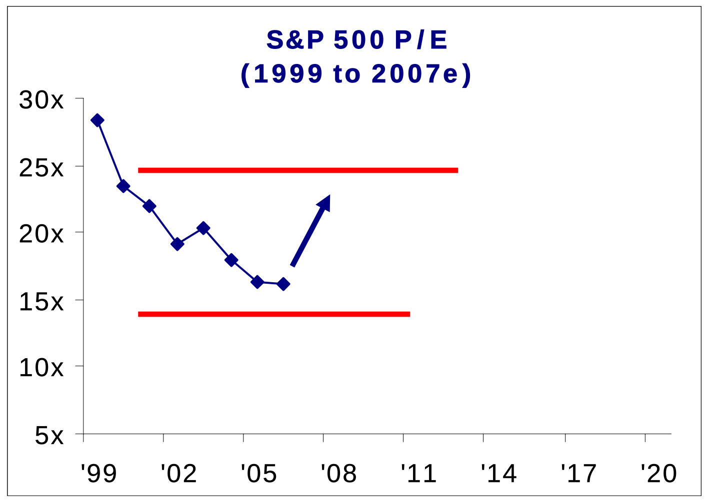
In contrast to the late-'90s, however, we **do not** anticipate such a marked "recovery" in the pace of corporate profit growth following this quarter of imbalance. Unlike LTCM in 3Q '98 the current imbalances in the credit market suggest questions will persist for a while longer. Street expectations for 4Q for the Financials sector now stand sharply lower Y/Y at -14%. Financials constitute nearly 30 pct of S&P 500 profits.

HISTORY SUGGESTS WE'RE IN A PERIOD OF SECULAR MULTIPLE CONTRACTION

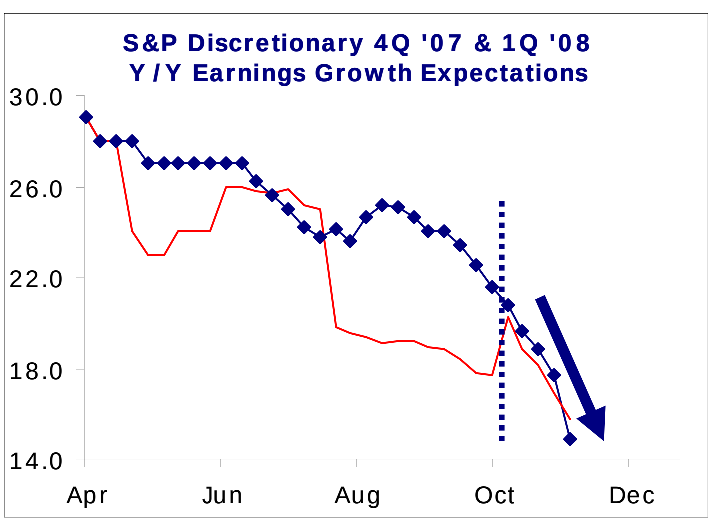




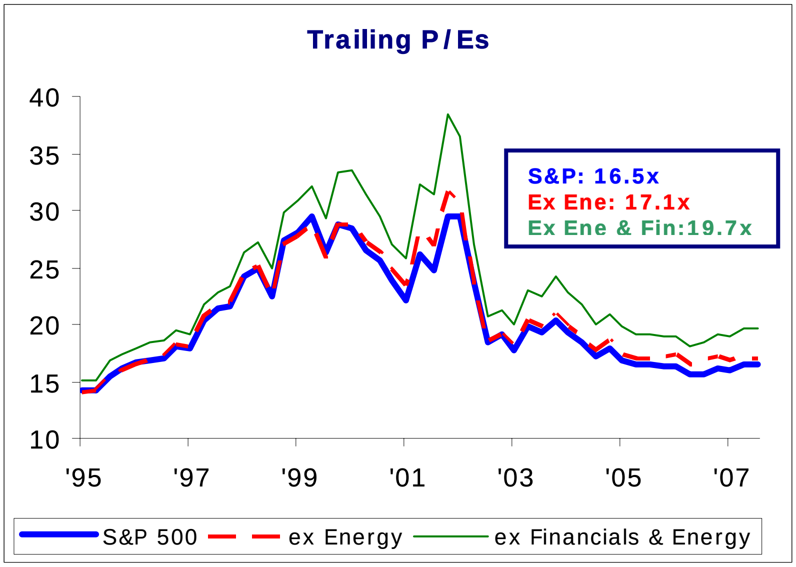




STREET HAS STARTED TO LOWER DISCRETIONARY SECTOR EARNINGS EXPECTATIONS IN EARNEST

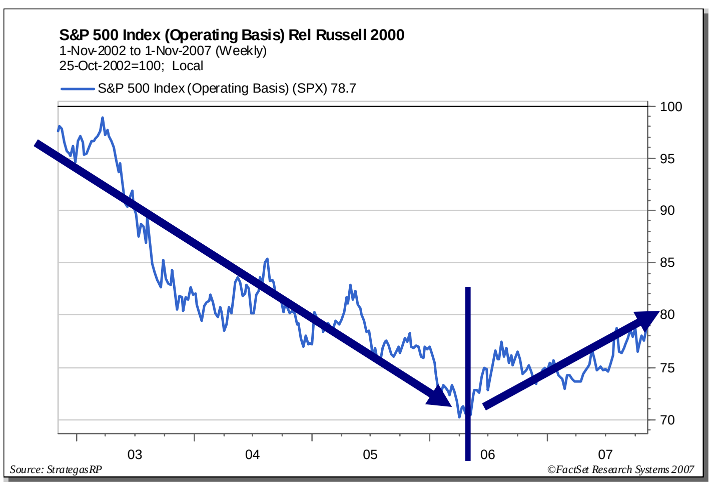


EVEN ACCOUNTING FOR "PEAK" EARNINGS VALUATIONS STILL REASONABLE



Given an earnings yield of 6.0% and a 10-year yield of 4.3% we believe the downside risk for the market is low and the potential rewards quite high. One objection to this argument is the claim that Energy stocks are being valued at "peak" earnings and therefore depressing the market's "real" valuation. Stripping out the impacts of both the Energy and Financials sectors reveals, however, that the market is still relatively cheap, especially when compared to the risk free rate.

TREND IN LARGE-CAPS OUTPERFORMANCE NOW CLEAR



While not by much, U.S. large-cap shares appear to have turned the corner relative to small-caps