

INVESTING WITH DISCIPLINE

NEWSLETTER

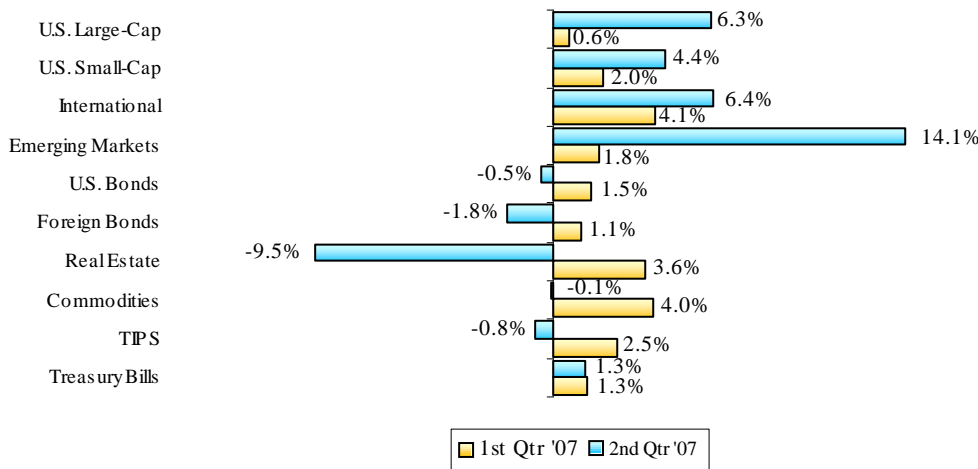
JUNE 30, 2007

MARKET UP-DATE

The 2nd Quarter of 2007 was a mixed bag, and the month of June was particularly difficult. As usual, uncertainty in the economy provided the catalyst for volatility. Stocks performed very well, with broad U.S. and international indices gaining over 6%. Bonds of all types—U.S., foreign, and inflation protected—lost money during the quarter. Interest rates spiked in June, prompting most of the losses. Real estate investments declined roughly 9% due to housing market concerns. The economy appears to be absorbing the blows of the downturn in housing, but this slowdown has undermined the rate of economic growth in the first half of this year.

Looking forward, the housing slump continues to be a worry, but other sectors of the economy appear to be doing well. The world economy continues to grow, helping US exports. Interest rates have stabilized and bond yields are beginning to normalize with longer term rates rising and are not too far below short term rates.

For additional charts and information about the previous quarter, please visit our website and see our Quarterly Review & Outlook in the Archive section.



INDEX SCORE-CARD

QUARTERLY RETURNS

S&P 500:	6.28%
Russell 2000:	4.42%
Lehman Aggr.:	-0.89%
MSCI EAFE:	6.40%
Wilshire REIT:	-9.47%
Commodities:	1.09%

All data as of the period ending
6/30/07

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QUARTERLY TOPIC: PRIVATE EQUITY

Ladies and gentlemen, Elvis has left the exchange.

The company that owns Graceland and other Elvis properties (CKX Inc.) agreed on June 1st to be purchased by a group of private investors for over \$1b and delisted from the NASDAQ Stock Market. The buy-out marks a trend we have seen accelerate this year – an increasing number of companies traded on the New York Stock Exchange or NASDAQ are moving from public to private ownership structures.

The buy-out trend is being driven by Private Equity firms, including Kohlberg, Kravis, and Roberts (KKR), Blackstone, and Bain Capital, who create pools of 'private' capital by raising money from wealthy individuals and other investment firms. The money is leveraged, magnifying its buying power through borrowing huge sums from banks and financial institutions. The cash and borrowed money are then used to purchase a company that is believed to be underperforming and/or undervalued. If a buy-out and turn-around is successful, the company is sold back to the public in 3-5 years. Leverage from the large

QUARTERLY TOPIC: PRIVATE EQUITY (CONTINUED)

amounts of borrowed money magnifies the gains and losses, similar to how mortgage debt magnifies the gains or losses to a person's home equity.

Private Equity deal-making has accelerated over the past few years, rising from under \$100b of total deal value in 2001 to over \$700b in 2006. According to the Wall Street Journal and Thomson Financial, the number of deals has tripled from a year ago and most have involved publicly traded companies. These include the \$7.4b purchase of Chrysler by Cerberus Capital Management LP and Goldman Sachs' purchase of Alltel Corp for \$25.7b, the 3rd largest leveraged buy-out in U.S. history.

Sustaining the flurry of transactions is a flood of cash into private equity coffers. Countless billions have been raised from wealthy individuals and institutions. Bank loans have been secured on usually favorable terms. Easy money is symptomatic of an environment where investors are pushing the risk envelope in an effort to diversify away from traditional stocks & bonds or find the next hot asset class. However, the easy money could dry up quickly. Interest rates are rising, which makes loans more expensive and sets a higher bar for the investment returns needed to justify borrowing money. Also, banks and other institutions are becoming more wary lenders. Problems in the sub-prime housing market have already hit lenders with a nasty surprise and they do not want another. Finally, as prices for distressed companies are bid up by this flood of capital, both the availability and the attractiveness of good investments will diminish.

Executives within the industry are divided, some warn that private equity is a bubble and others suggest this is the golden age of deal-making. Michael Psaros, a managing partner at KPS Capital Partners, when asked recently about prices being paid for companies, was quoted in the Wall Street Journal as saying, "We are selling everything that isn't nailed to the floor at prices that are between stunning and inconceivable."

In an ironic move, two of the most prominent private equity firms, Blackstone and KKR, have issued or will be issuing initial public offerings of stock. Private equity firms going public?

Their move to go public has a few implications. First, it could be a

sign the market is frothy and executives of the Blackstone and KKR are trying to cash in at the top. Blackstone's CEO is estimated to be worth over \$10b after their IPO. More importantly, the IPO's of private equity firms indicates that both private and public ownership structures have benefits. Publicly traded stocks on the NYSE and NASDAQ benefit from very deep and liquid markets. They can raise capital by issuing stock or bonds to a very broad base of investors. Privately owned companies benefit from a lighter regulator environment and less shareholder scrutiny which translates into more operating flexibility. They can focus on longer investment time horizons of 3-5 years rather than be pressured to provide steady quarterly earnings. In a major vote of confidence, retired legendary CEO's Jack Welch (GE) and Lou Gerstner (IBM) are both involved with private equity firms.

Some investor advocates are worried about the loss of companies from the exchanges and the draw of talented managers from public to private companies. They worry this trend will potentially make a larger portion of the capital markets accessible only to the ultra-wealthy, leaving Joe-investor out of the game. We are not overly concerned. While Elvis may have left the exchange, approximately 200 companies per year since 2004 have conducted initial public offerings, subjecting themselves to public scrutiny and giving the average investor a chance to buy their shares. Furthermore, the capital markets will continue to evolve and run through their various cycles. Private equity is no different. The flood of cash will at some point recede, but they will continue to play an important roll. Since Headwater utilizes index funds, our portfolios will include shares of private equity companies that list their shares. The cross-over of these two worlds, private and public, ultra-wealthy and average Joe, should benefit everyone in the long-run.

Regards,
Brian J Lawrence, CFA

WIT & WISDOM

"If life was fair, Elvis would be alive and all the impersonators would be dead." - Johnny Carson

Index Definitions

S&P 500: A U.S. large company stock index. A group of 500 of the most widely traded stocks in the U.S., as selected by Standard & Poors.

Russell 2000: A U.S. small company stock index. The smallest 2000 stocks in the Russell 3000 Market Index.

Lehman Aggregate Bond: A total bond market index, including corporate, government, mortgage and asset backed securities.

MSCI EAFE: An index of foreign stocks in the developed markets of Europe, Australia, Asia and the Far East.

Wilshire REIT: A composite of Real Estate Investment Trust traded on the U.S. stock exchanges.

Commodities: Performance is represented by the PIMCO Commodity Real Return Strategy Fund, which uses the DJ AIG Commodity Index as a benchmark.

TIPS: Treasury issued bonds whose principal value is indexed to the CPI, thus rising and falling with inflation.

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