INVESTMENT PERSPECTIVES
QUARTERLY UPDATE – OCTOBER 1, 2008

BROWN ADVISORY

ARE WE THERE YET?

It's been a long, tough road over the last year or so. A stressful stretch of credit crises, rising commodity prices and falling stocks has challenged investors like so many storms, fallen trees and potholes. Reflecting distress, bewilderment, and even impatience, many investors are asking themselves, "Are we there yet?" Translation: "Are we finally near the end of the cycle?" or, more candidly, "Is this nightmare almost over?"

Like late summer hurricanes, September's wild market gyrations may herald some sort of change--perhaps an inflection point in the market cycle--since exceptional volatility often signals a shift in the environment. Only time, however, will tell us the shape of this change. As always, but especially now, our job as investors is to make sure our clients are cushioned to an appropriate degree against adverse conditions while maintaining the ability to profit when the markets eventually recover. Although the bulk of our energy is spent choosing the best securities to populate our various portfolios, we also pay close attention to the overall economic and market environment to make sure our asset allocation makes sense in each client's individual case.

There's no easy answer to the question of where we are in the market cycle—any more than trying to estimate the length of a trip through unfamiliar territory, downed power lines and heavy traffic. We start with an assessment of economic developments and their likely future direction, since, in the final analysis, the markets reflect the underlying health of the economy and corporate profits. The challenge is complicated, however, by the need to take into account investors' perception of the facts as they unfold and by the market's tendency to discount future developments well ahead of the time they become clear.

As a firm focused on fundamentals, we add a generous measure of gritty reality to this process by listening carefully to what companies are saying about their businesses. Our three major U.S. large-cap portfolios contain a total of 100 or so leading companies that in many respects are bellwethers of the economy, and our analysts are regularly in touch with at least twice that many as they monitor their respective industries. What they tell us is always helpful—and today, not as dire as the market seems to suggest.

Three Primary Issues

As we see it, there are three broad clusters of data that have driven the markets' swoon over the last year—the credit crisis, inflation, and the consumer. And of course, they are related. Let's take them in turn.

The credit crisis that has ripped through the financial sector is certainly the most alarming and potentially most threatening of recent developments. What started as a seemingly isolated problem in sub-prime mortgages about 18 months ago turned out to be an early warning signal of larger problems to come. Although most of what we read about now is related to write-downs of credit instruments on commercial and investment bank balance sheets, the main culprit is housing prices, which are down about 20% from their peak, according to the Case-Shiller index. When coupled with the exceptionally high degree of leverage that many financial institutions reached during the long period of easy money, the result was toxic. Much of Lehman Brothers' difficulty, for example, was related to its large holdings of real estate securities on a highly leveraged balance sheet, together with its inability to raise enough capital to offset the loss in their value and restore confidence.

To date, as we head into the third quarter reporting season, well over $250 billion in write-offs has been announced by financial services firms, while about $175 billion in fresh capital has been raised to offset most of that amount. Further losses can be expected to be announced in coming weeks since the credit markets have weakened further, sending the value of various instruments lower. At the same time, most lenders, sobered by the pain of having been highly leveraged at the peak of the cycle, are now desirous of reducing their debt loads at the very time when there's little demand for the securities they need to

sell in order to de-leverage. If they choose to unload those securities at distressed prices, it would intensify the downward pressure and trigger another round of losses. The Treasury's broad rescue plan should help address this issue by providing a market for these securities.

Compounding the problem is that those firms that have the most exposure to additional write-downs can't raise new equity capital without incurring huge dilution because their share prices are so severely depressed. If the housing and related markets stabilize, the need for additional write-downs (and therefore for additional capital to be raised) would begin to subside, but the danger is that further erosion in real estate values could set off a further spiral downward. In the meantime, lenders are husbanding every dollar of their capital in an attempt to reduce leverage, by reining in their lending. In an economy that has thrived on readily available credit, this de-leveraging process is restraining growth and could ultimately push the U.S. into recession.

The second set of issues is related to inflation, and there the news seems to have moved from a significant risk to at least a neutral or probably even a plus. As oil and other commodity prices spiked to dramatic new highs earlier in the summer, they drove overall inflation well above acceptable levels. That would have left the Federal Reserve little choice but to hike interest rates to combat inflation at the very time economic growth was decelerating. The ugly prospect of stagflation weighed heavily on the markets in the late spring and summer. Since then, commodity prices have pulled back substantially. Added to slack in the labor markets, which has kept wage costs in check, the downtick in commodities appears to have removed, at least for now, the near-term prospect of runaway inflation. One measure, the implied inflation rate in Treasury Inflation Protected securities (TIPs), suggests that inflation will settle out at less than 2% over the next several years. This outlook gives the Fed more room to pump additional liquidity into the system to help ailing financial institutions manage their balance sheets and stimulate the economy at a time when growth is waning.

In the midst of this turmoil, the consumer has been comparatively stable, as retail spending has softened but not collapsed as many had feared. Last summer's tax rebate kept sales artificially high, and now that the effects have subsided it will be interesting to see where they settle out. The combination of forces at work suggests that spending isn't sustainable at its current rate. Measures of consumer confidence were recently at or near historic lows, and the unemployment rate has ticked up to 6.1%, the highest level since the last recession, in 2001-02. Over time, the tightening of bank credit is also bound to dampen spending. On the positive side, the recent collapse in oil prices will certainly help ease the pressure that many (especially lower income) consumers felt, and further tax relief for middle-income taxpayers could be on the way, depending on the outcome of the election. While more restrained spending and a higher savings rate would ultimately be a good thing for the economy, the near-term effect would clearly be negative.

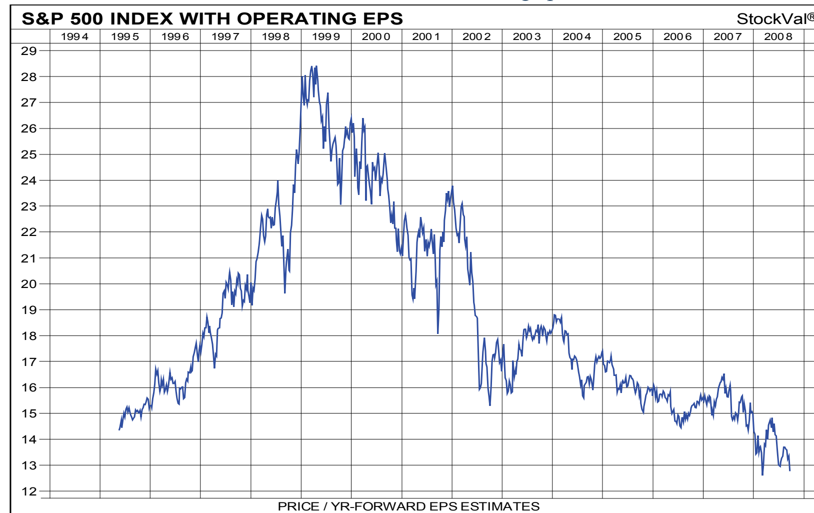
Valuations Favor Equities

Amidst these cross-currents, it's important not to lose sight of the basics of earnings and equity valuations—and frankly that's where we remain primarily focused. Gauging the likely course of profits over the next year or so is complicated by the financial sector's recent losses. That group accounted for about a quarter of corporate earnings at their peak in 2006 but in the latest twelve months the figure is negative. While financial earnings have fallen, non-financial companies have shown fairly solid profit gains to date, and the outlook for the full year is still positive at this point--up about 10%. What's hard to judge is the degree to which the problems in "Wall Street" will translate into problems in "Main Street"—that is, how rapidly will credit constraints force a contraction in the "real" economy. As non-financial earnings begin to come under pressure from slowing growth and currency headwinds over the next few quarters, the financial sector should experience sharply improving year-over-year comparisons as the need for write-offs will eventually diminish.

Factoring in these countervailing forces, we think a reasonably conservative 2009 projection for the S&P 500's earnings would be in the range of $90 per share. On the basis of that figure, the Index is now trading around 14 times the estimate. As shown in the accompanying chart, the historic 15-year range of multiples based on forward estimates has been 12-28X, so in that context the market appears reasonably priced. Further, given the low level of interest rates (and presumably inflation), price/earnings ratios should move higher as confidence in the financial system begins to be restored. In the midst of a crisis as severe as the present one, it would be foolish to predict when that will happen, but it's important to remember at times like this that markets are cyclical.

S&P 500 P/E Ratios, 1995 – 2008

Based on 12-month forward earnings per share



As we've said in recent communications, the economic recovery is likely to be "bumpy" and slow because of the de-leveraging process that has to take place over what could be a several year period. Nonetheless, it appears that equities have reached a valuation level that discounts a great deal of negative news and overlooks the favorable prospects of many well positioned companies. In that context, we recommend slightly overweighting stocks versus fixed income securities on a "tactical" basis (i.e., relative to a client's strategic asset allocation plan). Within equities, the emphasis should be on quality and predictability of earnings, although it's helpful to spread one's exposure across market capitalizations, sectors and geographies. Still, there is significant risk of further near-term price erosion, given current disruptions in the credit markets, and for that reason we have long advocated that clients keep some extra cash in their accounts.

As always, diversification remains a critical factor in containing risk, especially in stormy markets. Appropriate diversification comes in two forms, both of which are important in managing client assets. The first and most obvious is making sure that one's assets are allocated across various asset classes and investment styles. Second is that balance should be maintained within each asset class by diversifying across sectors (health care, technology, etc.) and types of securities (growth, value, large-cap, small-cap, etc.).

New Colleagues

We're very pleased to welcome our new Alex. Brown Investment Management (ABIM) colleagues, who joined the firm in early August and moved into our Baltimore headquarters in mid-September. The combination of our two firms feels like a home-coming of sorts, since we knew each other well as affiliates of Alex. Brown & Sons and have continued to work together in serving selected clients since separating from Alex. Brown a number of years ago. In fact, we've long considered the possibility of combining our firms because of our shared values and culture, in addition to our common heritage. We've known the principals of the firm since its formation in the 1970s and have nothing but the highest respect for their investment expertise.

ABIM is best known for its "flexible value" investment style, which has produced superb results over a long period of time. This distinctive style will continue to be managed by the ABIM team, which now has access to the additional research resources that Brown Advisory has developed over the years. On a combined basis, our firm has more than 20 analysts, providing us with greater depth and a wider network from which to draw investment ideas and to vet ones that we originate. We firmly believe that the best investment results are produced by an experienced team of analysts and portfolio managers working together in a spirit of teamwork and collegiality. At the heart of the process is an environment that encourages free and open exchange of views. ABIM shares this vision.

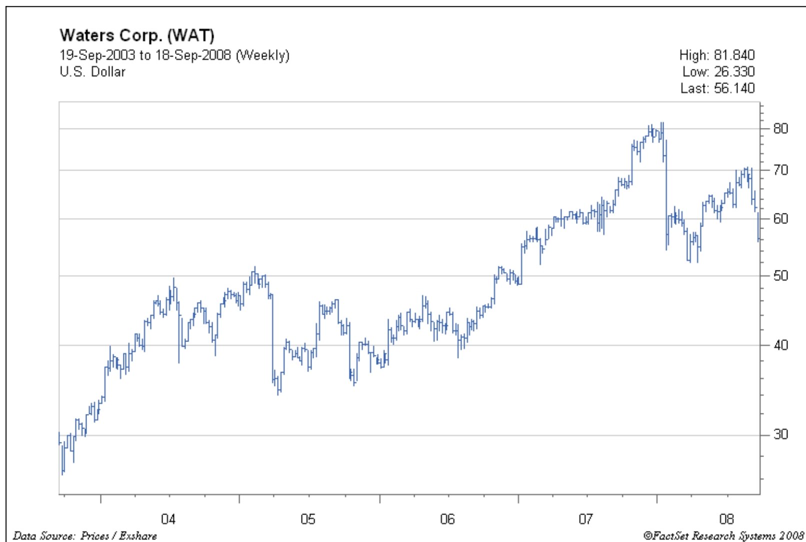
Our new colleagues also share the belief that independence is critical to the ability to think creatively, without restraint or conflict of interest. In the present environment, it's comforting to be able to work without the distractions that so many firms with uncertain financial futures have faced.

William L. Paternotte, CFA

Strategic Investment Committee

INSIDE THE PORTFOLIOS

Waters Corporation (WAT)



Each quarter, we highlight a company in our portfolios to illustrate how Brown Advisory's research process works.

Waters Corporation is the world's leading supplier of biochemical analytical tools for biomedical research, drug discovery and development, and environmental testing. It also develops and markets thermal analysis and rheometry instrumentation, which is used by industrial companies in quality control and new product development. The "tools" that Waters provides are technologically innovative and critically important to its customers, in that they increase R&D productivity and shorten the time-to-market in developing new products.

In its early history during the 1960s and 1970s, Waters was a pioneer in two significant and related scientific developments—liquid chromatography and mass spectrometry. These technologies enable laboratories to measure the chemical, physical and biological composition of materials--processes that now have a broad array of applications. Examples include monitoring the purity of water and air for environmental purposes, or making sure that pharmaceuticals contain no impurities in the manufacturing process. More recently, the Company's TA Instruments division's innovations in thermal analysis and rheometry instrumentation have allowed companies to predict the suitability of fine chemicals and polymers for uses in various industrial, consumer goods and health care products.

Combining its traditional business and TA, Waters is one of largest companies in the analytical instruments industry, supporting scientists working around the world. As a result, its geographic exposure is well balanced. About a third of revenue comes from each of the three geographic regions: U.S., Europe, and Asia-Pacific.

Paul Li, our senior health care analyst, has been focusing much of his attention on companies that promote higher productivity among laboratory workers. His thinking is that companies like Waters benefit broadly from the development of new drugs and the production of existing ones, without being dependent on which particular drugs are successful. By supplying "tools" that enable labs to function more effectively, the Company has become essential to its customers' success while spreading its "bets" across a large number of growing product areas.

While Waters' growth in the near term has been negatively affected by the restructuring and cost cutting measures recently implemented by some of the biopharmaceutical companies, its long-term growth prospects remain very positive. Paul Li expects the Company to grow its revenue at a reasonably predictable rate of 7-9% a year. Through favorable operational leverage, he thinks earnings can increase at more than 10% compounded, as management has a proven record of execution. At its current valuation of about 17 times our 2008 estimate of earnings per share and 15 times next year's projection, the shares represent excellent value for long term investors, in our view.

Brown Investment Advisory & Trust Company prepared the information and opinions expressed in this report. Brown Investment Advisory & Trust Company and Brown Advisory Securities' combined beneficial ownership of the security mentioned in this publication is less than 1%. The research analyst certifies that: (a) the views expressed in the research report accurately reflect the research analyst's personal views about the subject security and company; and (b) no part of his compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in this research report. Readers should not assume that investments in the securities discussed were or will be profitable.

Brown Advisory is the trade name of Brown Investment Advisory & Trust Company and Brown Advisory Securities, LLC

901 South Bond Street • Suite 400 • Baltimore, MD 21231
phone 410 537 5400 • 800 645 3923

7475 Wisconsin Ave • Suite 800 • Bethesda, MD 20814
phone 301 718 8600 • 866 489 0303

1737 H Street, N.W. • Fourth and Fifth Floors • Washington, D.C. 20006
phone 202 452 9600 • 866 838 6400

200 Westage Business Center Dr • Suite 228 • Fishkill, NY 12524
phone 845 897 1560 • 877 949 6100

230 Park Avenue • Suite 1813 • New York, NY 10169
phone 212 277 7207

150 Brompton Road • Floor Four • London, UK SW31HX
phone 011 44 207 591 7084

www.brownadvisory.com