Mesirow Financial®

Investment Management Newsletter

FALL 2007

CURRENCY MARKET OVERVIEW

The Washout from the Credit Crisis

by Fred Stambaugh
Managing Director – Currency Management

The U.S. mortgage crisis hit the global markets with gale force in the third quarter. The difficulties spread from structured derivatives to mainstream funding markets, causing systemic liquidity problems. As asset markets gyrated, central banks pumped liquidity into the markets, culminating in a 50 basis point rate cut by the Federal Reserve in September.

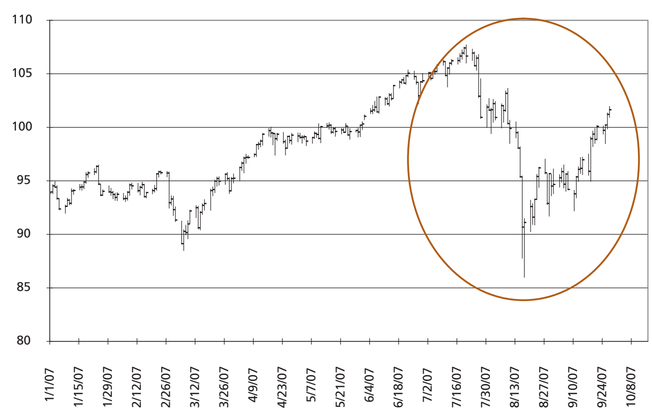
The currency market responded with variations on the themes that have characterized 2007: a weakening dollar and a rejection of, followed by a return to, the carry trade. Broad price swings focused investor attention on currency risk.

The dollar began the quarter continuing its Q2 decline, touching new multi-year lows against the GBP, AUD, CAD and EUR. Then word began to spread of IPO's, hedge funds and some sponsoring banks having difficulty raising liquidity. Amid the sell-off that ensued, the dollar enjoyed a rebound as investors shed risk positions for the safety of U.S. Treasuries.

On August 17, however, the Fed took vigorous action to provide liquidity to the market, including lowering the rate for discount window borrowings. This stopped the dollar rally in its tracks and started a long decline that continued through to the end of the period.

Meanwhile, the carry trade – borrowing low yielding currencies such as JPY and holding high yielders such as AUD – was buffeted by the credit market storms. As the liquidity crisis hit, carry investors rushed to liquidate their positions. The yen strengthened sharply and the high yield currencies plunged as a result: the AUD JPY cross rate fell an unprecedented 20% between July 20 and August 17. With the Fed's intervention, both currencies reversed course, and the cross rate ended the quarter only 2% off its previous close (*see chart at right*).

AUD/JPY Daily Spot Price



Source: Mesirow Financial Investment Management, Inc.

continued on p. 6

PRIVATE EQUITY MARKET OVERVIEW

Buyout investment pace grinds to a halt

by Marc E. Sacks
Senior Managing Director – Private Equity

Over the past several months, concerns in the U.S. subprime mortgage market spread into other areas of the credit market, triggering a crisis of confidence that effectively shut down access to asset-backed commercial paper. As a result, the record-setting deal activity by buyout sponsors came to an abrupt standstill as the high-yield and bank debt markets reassessed the risks of lending to highly-leveraged acquisition targets.

While still too early to judge its full impact, this credit market disruption was the first major blow to a four-year period of incredibly favorable conditions for leveraged buyout sponsors, specifically: Low interest rates, easy credit availability and rising corporate profits. During this period, large buyout sponsors, in particular, generated record distributions and returns for investors. Through

continued on p. 6

IN THIS ISSUE

A Rough Ride for Hedge Fund Investors

by Stephen C. Vogt
Senior Managing Director – Advanced Strategies

The third quarter was clearly a challenging period for hedge fund investing. History will likely regard this past quarter as a critical period of stress from which many lessons can be learned. The lessons will include the impact that long periods of substantial global liquidity can have on market volatility and risk premiums. Other lessons will be the eventual willingness of market participants to take on risk in an effort to enhance returns and how those risks can accumulate to create systemic hazards that can spread to all aspects of the financial markets by way of seemingly unrelated conduits.

The lessons, of course, are not really new. They are simply a new set of study questions at the end of another chapter in a textbook on a financial market crisis. The answers to those questions are also not new. In the end, the primary lesson re-learned from the market crisis of the third quarter is that misaligned incentives combined with an inappropriate level of leverage applied to assets ill-equipped to support that leverage creates serious and sometimes very perverse problems in the financial system. In this particular case, high levels of global liquidity created an environment for low market volatility and cheap risk premium. This environment led to excesses in financial engineering and permitted distortions to arise in the housing, leveraged buyout and corporate loan markets that could not be sustained. The break came as investment banks and other investors that leveraged asset backed securities and corporate loans saw a disconnect between what models indicated and what the markets said the securities were worth. This disconnect was the spark that created the need for liquidity as subsequent mark downs on the value of these assets warranted the need for additional equity to support them. The market contagion occurred when these investment bank trading desks and certain large multi-strategy hedge funds began de-leveraging their quantitative market neutral equity programs ("Quants") to raise cash. These programs may have been over leveraged because risk models allowed it in this period of low market volatility. This de-leveraging created wide spread perversion in both the credit and equity markets with higher quality, more liquid securities being sold off and lower quality, less liquid securities either not moving (credit markets) or actually rising (equity markets) as the Quants covered short positions. The result was a brief period of financial stress occurring in the last week of July and first two weeks of August that the markets had not seen for the better part of five years. In fact, some market observers would suggest that, given the leverage involved, this level of stress had not been seen since the Long-Term Capital Management crisis in August of 1998. Recall that system-wide leverage even in the difficult times of June-July 2002 was very low and consequently contagion problems were reasonably well contained.

If the stress to the system during the third quarter was on par with August 1998, one is left wondering why there was seemingly so little overall collateral damage to the system. After all, the equity markets ended up in August and loan prices bounced back in the second half of August. Here the answer is somewhat different from past lessons yet still has similarities. The marketplace for leverage is considerably more mature then it was in 1998. Financial engineering, despite all the negative press received in this situation, is very effective at dividing risk and applying leverage into security tranches that can be sold to specific investors. These investors are capable of taking on that risk, thereby diversifying it more broadly throughout the economy. Additionally, the hedge fund, prime brokerage and banking industries are much more mature today and financing sources are much more stable than they were in 1998. The result was that the overnight re-pricing of collateral and rapid retraction of lending facilities and swap lines that occurred in 1998 did not occur today since more term financing is in place and banks are more appropriately structuring and hedging those facilities. This combined with prompt action by both the European Central Bank and the U.S. Federal Reserve Bank in August to provide liquidity to the system and reduce pockets of stress was apparently sufficient to contain any further problems. The central bank response is not a new answer and one that has been successfully applied in the past, but it is also an answer that runs the long-run risk of increasing moral hazard problems among financial institutions.

As we enter the fourth quarter we are compelled to ask what has changed and what are the risks and opportunities going forward. One result of the events of the third quarter is that there is clear evidence that certain excesses have been reduced while others still remain. Market participants are clearly more sensitive to leverage now as bank trading desks and certain hedge funds or Quants are now clearly operating with lower levels of gross exposure on their books. Excesses in the corporate LBO market have also been removed. The market for covenant-lite deals and/or deals with payment in kind features appears to be slowing. The ABS marketplace is clearly no longer supporting such deals, at least without significant restructuring or re-pricing. However, the appetite for well-structured deals and particularly strategic deals is likely to remain good. Banks that were involved in creating structured credits for both the real estate market and the LBO market are clearly writing down losses this quarter and probably next quarter in a sign that they are proactively repairing balance sheets so as to continue lending. The corporate loan market, in general, is no longer as hearty as it was, however prices are still fairly robust and credit spreads, while wider, are still reasonably tight relative to historical norms.

Unfortunately, the opportunities created by the stresses in the third quarter were very short lived. Bank loans had a brief two week period of discount pricing that was partially recouped

continued on p.3

Feature Article, *continued from p. 2*

before the month of August ended. Much of the talk about opportunities in hung bank loans associated with LBO financings were fairly limited as a large amount of capital has either been raised or otherwise come off the sidelines to create pricing that many managers do not deem to be attractive. A concrete example of this is the First Data Corporation – KKR deal that closed recently. Many managers had hoped the loans for that deal would be priced around 92 thereby providing a strong profit opportunity. However the loans were priced at 96 and because the demand was so strong twice the quantity of loans were offered to the marketplace. Opportunities in the equity space also were recouped in the later part of August and early September with loose neutral hedged equity managers being the beneficiaries. Somewhat counter-intuitively, our view of the opportunity set going forward has come roughly full circle since our last newsletter. The angst we expressed about potential market dislocations has been reduced. Yet we still are closely monitoring the cross currents associated with a slowing U.S. economy, robust and growing global liquidity post the recent central bank actions and reasonably strong economic growth continuing around the globe, in particular, Asia. Slowing U.S. growth almost certainly suggests increasing corporate default rates and a recession could cause rates to rise dramatically and create a significant opportunity in the distressed credit area. A slowing economy could also put pressure on corporate profits which could impact the U.S. equity markets. The weakening dollar also has the potential to affect growth internationally and particularly in parts of Europe, such as Germany, where internal aggregate demand is less robust.

INSTITUTIONAL REAL ESTATE—DIRECT INVESTMENTS MARKET OVERVIEW

Apartments – the Effect of Demographics on Demand

by Alasdair Cripps
Senior Managing Director – Institutional Real Estate-Direct Investments

Despite the recent troubles in the residential real estate market, the demographic trends point to a relatively rosy future for the apartment rental market. In order to project future apartment demand, it is important to examine generational birth rates while understanding the social, political and economic issues that differentiate the groups.

In evaluating the relevant population for apartment demand, the market can be divided into four generational groups. The first generation is the "Baby Boomers," which is made up of those born between the end of World War II (1946) and 1964. The Baby Boomers are defined by a record high number of births topping out at a high of 4.3 million in annual U.S. births in the late 1950's. The second generation is "Generation X" (also known as the "baby bust era") which is generally defined as the time between 1965 and 1976 and encompasses a low of 3.0 million in annual birth rates in the early 1970s. The next generation is referred to as the "Echo Boomers." These are the children of the Baby Boomers, defined as those born between 1977 and 1994 and currently totaling 75 million. The most recent generation is the "Millenials" which are defined as those born beginning in 1995 through today and total 48 million. The important takeaway from this is that these last two groups represent 123 million people and counting of which only a fraction has thus far entered into the housing market.

Age	Rentership Rate	Household Renters (000) in 2005
5-14	0%	0
15-24	74.3%	5,167
25-34	50.7%	9,807
35-44	30.7%	7,246
45-54	23.4%	5,486
55-64	18.8%	3,289
65+	19.4%	4,498
Total		35,493

Source: Census Bureau & Joint Center for Housing Studies

Age in 2005	Renters in 2005 (000)	Age in 2015	Renters in 2015 (000)	Change (000)
5-14	0	15-24	5,431	5,431
15-24	5,167	25-34	11,079	5,912
25-34	9,807	35-44	6,860	(2,947)
35-44	7,246	45-54	5,641	(1,605)
45-54	5,486	55-64	4,407	(1,079)
55+	7,787	65+	5,742	(2,045)
Total	35,493		39,160	**3,668**

Source: Census Bureau & Joint Center for Housing Studies

The other important factor to analyze in projecting apartment demand is the propensity of various age groups to rent versus owning a dwelling. The first table at left illustrates this propensity for the year 2005.

The demographic data shows that the Echo Boomers and Millenials will move into apartments in droves as they enter the 15-24 and 25-34 rentership categories (assuming the rentership rates stay the same in 2015 as was in 2005). Based on the populations of these generations relative to those preceding them, it is projected that almost 20 percent more renters will emerge over the next ten years. While many factors such as housing prices (single family and condominium), immigration, available credit, job growth and construction costs will affect apartment demand, it is clear that based on the future demographics, demand for apartments will continue to be strong. The second table illustrates this future trend, with a projected increase of almost 3.7 million renters by 2015.

This data certainly gives institutional investors a reason to feel optimistic about the future investment potential of the apartment market.

EQUITY MARKET OVERVIEW

CRISIS OR CORRECTION?

by Michael A. Crowe
Senior Managing Director – Equity Management

When we wrote our second quarter commentary in early July, we noted several risks in the prior year that could have broken the uninterrupted bull run of the past 5 years, such as high energy prices, the housing slowdown, the Chinese market correction, or even the subprime meltdown that was already underway. However, as we said at the time, we had a nagging feeling that something had to give, and "When the inevitable correction does come, it will be tempting to blame it on one of these factors. But if these conditions have not yet had a significant impact, then they probably won't in the future."

Well, the correction did come, and sooner than we thought. And, predictably, it was blamed on the subprime credit crunch. But throughout the correction, we held firm to our belief that it was merely a correction—triggered by an event with real risk for sure—but in the end still just a correction. No rational financial analysis could show that the threat of higher corporate borrowing costs or reduced consumer spending had reduced the aggregate value of the U.S. equity markets by 9%. Nor could any analysis show that the impact of a 50 basis point cut in the Fed discount rate should raise the value by 9%. Yet that is what the performance of the S&P 1500 index implied, as it dropped 9% between July 19 and August 15, then gained it all back by October 1.

Of course, financial markets are famous for overreacting. As value investors, we are well aware of, and quite thankful for, that phenomenon. But as analysts, it is also our job to assess cause and effect so that we can make sound decisions. Was the volatility of this quarter a result of a financial crisis that was narrowly averted by a quick Fed response? Was it a result of overreactions to these bona fide events? Or was it a long overdue correction that had these events conveniently hung on it? We think some of the former, but more of the latter.

S&P 1500 Performance (June 29, 2007 to October 1, 2007)

Source: Baseline

FIXED INCOME MARKET OVERVIEW

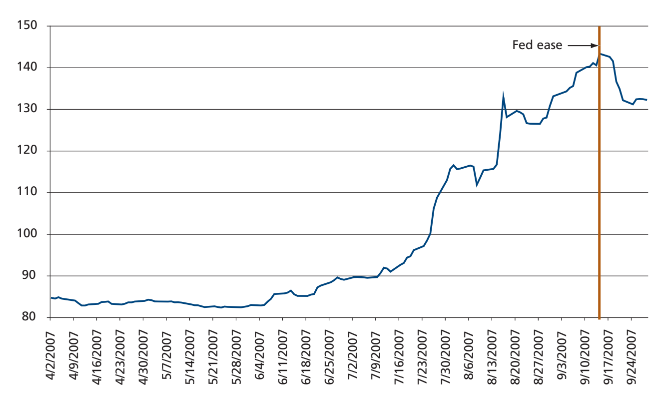
BERNANKE'S HEIMLICH SAVES CHOKING BOND MARKET

by Steven P. Luetger
Senior Managing Director – Fixed Income Management

The subprime mortgage debacle intensified as several mortgage-related hedge funds closed their doors, mortgage defaults spiked and home prices flat-lined. All sectors of the bond market were affected, not just those exposed to housing. The U.S. dollar hit a new low while gold went to a twenty-seven year high and oil hit an all-time high, adding to the general anxiety level. Bond market liquidity evaporated as volatility increased and bid-offer spreads significantly widened. The ensuing rush to the safety of U.S. Treasuries pushed interest rates lower, while yield levels on all other investment grade asset classes held steady. The result: extraordinarily wide yield spreads. Before the Fed stepped in and lowered rates by a more-than-expected 50 basis points, it looked like risk premiums were headed to levels not seen since the time of the WorldCom and Enron scandals. The action by the Fed calmed the market, at least for now, and liquidity and rational pricing are gradually returning to the bond market. As the chart shows, before the Fed lowered rates, yield spreads on corporate bonds shot up over 50 basis points. After the rate change, spreads recovered 10 basis points. However, news, real or rumored, that a large player is about to hit the wall could induce another liquidity squeeze and require further action from the Fed.

Treasury yields declined during the third quarter, particularly on the front end of the yield curve. The yield curve, while still relatively flat, steepened a bit as the spread between the two and ten-year Treasury increased almost 44 basis points.

Yield Advantage of Lehman Credit Index vs Treasuries



Source: Lehman Brothers

continued on p. 6

INSTITUTIONAL REAL ESTATE

INSTITUTIONAL REAL ESTATE EXPANDS FUND OF FUNDS TEAM


Sobczynski

Jeffrey Sobczynski recently joined Mesirow Financial's Institutional Real Estate Fund of Funds group as a vice president focusing on market research, manager research and operations. Sobczynski has over 17 years of real estate experience in consulting, financial reporting and asset management. Previously Sobczynski led the Midwest Practice of the Real Estate Consulting group at Deloitte & Touche where he served a variety of corporate and equity real estate clients with a specialization in real estate due diligence and M&A activity.

EQUITIES

EQUITY TEAM ADDS RESEARCH ANALYST

The Equity Management group recently expanded its research team with the addition of Cheryl Hua, CFA, as a senior research analyst focusing on the Mid Cap Value investment strategy. Cheryl has six years of investment experience, most recently as an equity analyst for Profit Investment Management/The Kenwood Group, Inc. She holds a bachelor's degree in international business and an MBA with a concentration in finance from the Illinois Institute of Technology, Stuart School of Business.

ADVANCED STRATEGIES

ADVANCED STRATEGIES SURPASSES $15B IN AUM

Since the beginning of the firm's fiscal year (April 2007) Mesirow Financial's Advanced Strategies, a hedge fund of funds manager, has continued to experience significant growth, with assets under management now surpassing $15 billion. This milestone comes on the heals of the group recently posting the best performance of any Mesirow Financial business in the firm's 70-year history, with revenue rising over 50% over the previous fiscal year.

PRIVATE EQUITY

PRIVATE EQUITY CLOSES VWR AND OPENPAGES INVESTMENTS

Mesirow Financial Private Equity, Inc. (MFPE) recently completed two new direct co-investments. MFPE participated alongside Madison Dearborn Partners to acquire VWR International, Inc., the second largest laboratory supply distributor in the world. MFPE also led a new round of venture financing for OpenPages, Inc., joining an investment syndicate than includes top-tier venture capital firms Sigma Partners and Matrix Partners. OpenPages is a leading provider of governance, compliance and risk management software solutions for Sarbanes-Oxley compliance, general compliance management, operational risk management and IT governance.

PROVIDING ACCESS TO LEADING PRIVATE EQUITY MANAGERS

Mesirow Financial Private Equity, Inc. (MFPE) continues to provide clients with diversified exposure to the world's most experienced venture capital and leveraged buyout managers. On behalf of clients, MFPE has recently committed to new funds raised by Draper Fisher Jurvetson, Battery Ventures, JMI Equity, Warburg Pincus, Kelso & Company, Fortress Investment Group and Sun Capital Partners.

PRIVATE EQUITY EXPANDS INVESTMENT TEAM

Kristina Meszaros and Ryan Fedronich joined the private equity investment team in July 2007 and August 2007, respectively. Kristina joins Mesirow Financial from UBS Investment Bank where she was an analyst in the Mergers and Acquisitions and Global Industrials groups. Ryan joins from Banc of America Securities where he was an investment banking analyst in the Consumer & Retail group.

CURRENCY MANAGEMENT

CURRENCY ADDS OPERATIONS ASSOCIATE

Currency Management recently hired Mark Lazarus as an operations associate. Mark's responsibilities include trade confirmations both internally and with counterparties, constructing timely reports and maintaining up-to-date records in MFCM's proprietary database.

COMPANY NEWS

UPCOMING MARKET OUTLOOK EVENT


Swonk

Mesirow Financial will hold its fourth annual Outlook Event on December 5, 2007 at the Chicago Marriott. Led by Chairman and CEO, James C. Tyree, and Chief Economist, Diane Swonk, the event will feature a panel of leaders from across the firm sharing their insight about the significant events that impacted the economic and investment landscape in 2007 and providing forecasts for what to expect in the new year. Event details will be available on our Web site at *www.mesirowfinancial.com*.

INTERNATIONAL ECONOMIST JOINS MESIROW FINANCIAL


Laurenti

Mesirow Financial recently added Adolfo L. Laurenti to the firm's economic research team, led by Chief Economist Diane Swonk. As Mesirow Financial's Investment Management business continues to grow overseas, Laurenti will focus primarily on international economic research, although he will also work alongside Swonk to develop ongoing economic research and commentary. Laurenti joins Mesirow Financial as a senior economist from LaSalle Bank/ABN AMRO, where he worked as an associate economist. A native of Milan, Italy, he is an active member of the National Association for Business Economics and the Chicago Association for Business Economics.

continued on p. 6

Private Equity Market Overview, *continued from p. 1*

Through the first half of 2007, there was a continued expansion of both leverage and valuation multiples as large buyout sponsors accelerated the deployment of capital into ever larger transactions.

Until the credit markets have substantially digested the estimated $300 billion backlog of leveraged financings, new deal activity by buyout sponsors will be sluggish at best. However, we do expect most of the already announced transactions will ultimately close after some renegotiation on the part of buyout sponsors, lenders and sellers. We expect lenders will seek additional covenant protections for their financing commitments and price concessions from sellers in a few exceptional cases. We anticipate leverage on new transactions will drop by at least one- to two-times cash flow and feature both more covenants and rate increases of at least 100 to 200 basis points. It will take some time for seller expectations to adjust, but we ultimately expect the valuation of new leveraged buyout acquisitions to decline in the second half of 2007. Long term, we view these developments as a healthy outcome for limited partners: LBO investment pace will moderate, new investments will receive greater scrutiny through due diligence and portfolio companies will employ lower risk capital structures. The investment banks have recently had moderate success selling off portions of large committed loan packages supporting LBOs (albeit at a discount), an optimistic sign that the liquidity crisis is beginning to recede.

Since 2005, the market average allocation to leveraged buyout funds in the U.S. and Europe has approached 80%. By contrast, we have consistently directed only about 60% of our partnership portfolios to U.S. and European leveraged buyout strategies. Leveraged buyouts will remain an integral component of our portfolios, but we will continue to balance our portfolios with meaningful allocations to venture capital and various special situations strategies. Finally, we will continue to allocate capital to buyout strategies which emphasize growth over extreme leverage, providing a more durable foundation to weather credit market volatility.

Currency Market Overview, *continued from p. 1*

These currency convulsions highlight the risk institutions face in their global dealings; this recognition is leading increasing numbers to seek to manage currency risks.

As the quarter came to a close, the dollar stood at all time lows against the EUR, CAD, and AUD; the GBP looked relatively weak, due to the UK economy's greater exposure to the credit squeeze, and the JPY and CHF traded soft with renewed carry trade activity. These trends looked set to continue.

Fixed Income Market Overview, *continued from p. 4*

The bond market, as measured by the Lehman Aggregate Index, returned 2.84%. The Lehman Government/Credit Index outpaced the Aggregate Index due to its longer duration and higher concentration of Treasury bonds. Treasuries produced the highest absolute and relative returns, rising 3.81%. All other asset classes, while producing positive absolute returns, dramatically underperformed the Treasury market. Corporate bonds underperformed Treasuries by over 215 basis points. The non-Treasury AAA-rated sectors, surprisingly, did not benefit from the market's flight to quality. Agency mortgages and high quality asset-backed securities underperformed Treasuries by 91 and 176 basis points, respectively.

News, *continued from p. 5*

INVESTMENT MANAGEMENT PROFESSIONALS HONORED WITH NORMAN AWARD


Zehfuss


Schilling

Michael Zehfuss, managing director in Currency Management, and Christine Schilling, assistant vice president in Institutional Sales and Marketing, were recently honored with the firm's very own, Norman Award. The Norman Awards were created in 2004 in honor of the firm's founder, Norman Mesirow, to recognize employees who have made significant contributions to the firm, our clients and our employees. Nominated by his peers, Zehfuss was presented with the Business Development Norman Award for his successful efforts in developing $1.25 billion in new assets during fiscal year 2007. Schilling was the recipient of the Emerging Professional Norman Award for her significant contributions to the growth of Mesirow Financial's Institutional Sales and Marketing effort.

CONTACT US

For more information contact Tom Hynes at 312-595-6934, or thynes@mesirowfinancial.com