

**CURRENCY MARKET OVERVIEW**

## THE RETURN OF THE CARRY TRADE

by Fred Stambaugh

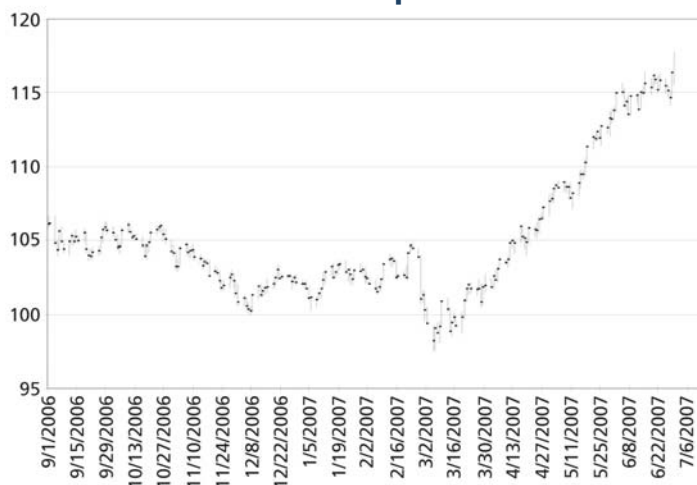
Managing Director – Currency Management

The currency markets in the second quarter of 2007 exhibited the usual cross-currents and confusion, but one factor had the clearest influence – the return of the carry trade. This strategy, in which cheap yen are borrowed to finance higher yielding investments elsewhere, has underpinned international investing for years. In February, hints of higher Japanese rates and official talk spooked the market and caused the yen to jump, profoundly shaking currency, stock and bond markets around the world.

This quarter, the market returned to the carry trade in massive quantities. The yen continued to weaken against virtually all currencies, while high-yielding currencies such as the Australian dollar (AUD), New Zealand dollar (NZD), British pound (GBP) and Canadian dollar (CAD) went from strength to strength. The CAD traded strongly, boosted by Canada’s strong economic performance despite weakness south of the border, and continued robust commodity markets. It touched a 25-year high against the U.S. dollar (USD) during the quarter, and rose an astounding 13.5% against the yen in the period.

For its part, the USD softened due to mounting concern that high fuel prices and weak housing markets will dampen growth and interest rates. Both the AUD and GBP touched levels against the U.S. unit that they had not seen in 15 years, rising 5% and 2%, respectively during the quarter. The euro also hit a record in its brief history, rising

**CAD JPY Spot Rate**



Source: Mesirow Financial Investment Management, Inc.

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**PRIVATE EQUITY MARKET OVERVIEW**

## CREDIT MARKETS SHOW SIGNS OF COOLING ON LBOs

by Marc E. Sacks

Senior Managing Director – Private Equity

During the first half of 2007, leveraged buyout activity increased six fold over the prior year and accounted for almost half of the period’s total mergers and acquisitions. Low interest rates and a flood of liquidity in the credit markets have been the primary fuel behind this buyout boom, enabling highly-leveraged multi-billion dollar acquisitions of unprecedented scale. Moody’s recently noted that “the unusually low level of defaults (near 12-year low as of June 2007) has led to investors showing less discrimination regarding credit quality, as evidenced by the increase in very low rated debt being issued on generous terms.” While lenders remain very aggressive from a historical perspective, there is evidence of a potential retrenchment in the credit markets as several recent borrowers have been forced to accept wider spreads and make other concessions to increasingly selective debt investors.

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# DIVERSIFY YOUR REAL ESTATE EXPOSURE – GO ACTIVE AND GO INTERNATIONAL

by Josh Daitch

Managing Director – Institutional Real Estate

Real estate is hot! Over the past 10 years, the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index has produced a 12.9% annualized return, real estate cap rates have dropped over 35% across almost every property type and tremendous capital has flowed into the marketplace. In 2006, \$682 billion was invested in direct commercial real estate around the world (only 40% in the U.S.), up nearly 38% over 2005 and nearly double the figure in 2003, according to Jones Lang LaSalle. We believe there are still good buying opportunities in this market due to rising rents and global economic growth, but the influx of capital means more real estate funds are chasing a limited number of deals. For that reason, investors need to be focused on careful manager selection and structure multiple layers of diversification to maximize risk-adjusted returns in their real estate portfolios.

Investing in international real estate in conjunction with more active managers should increase diversification and further reduce portfolio volatility. Real estate is the most localized asset class. For example, the supply and demand dynamics of the office market in Tokyo has very little correlation with the office market in Chicago.

## Publicly Traded REIT and Real Estate Related Security Correlations

	Singapore	Hong Kong	Japan	U.S.	U.K.	Switzerland	Spain	Italy	France	Germany	Denmark	Global Equities	Global Bonds
Singapore	1.00												
Hong Kong	0.51	1.00											
Japan	0.14	0.36	1.00										
U.S.	0.37	0.42	0.06	1.00									
U.K.	0.41	0.37	0.31	0.39	1.00								
Switzerland	-0.03	0.07	0.06	0.24	0.25	1.00							
Spain	0.22	0.11	0.05	0.00	0.08	0.39	1.00						
Italy	0.31	0.23	0.10	0.42	0.42	0.51	0.25	1.00					
France	0.26	0.24	0.14	0.56	0.56	0.63	0.36	0.72	1.00				
Germany	0.22	0.23	0.15	0.17	0.34	0.27	0.01	0.62	0.44	1.00			
Denmark	-0.08	0.19	0.12	0.20	0.10	0.25	-0.06	0.32	0.20	0.53	1.00		
Global Equities	0.27	0.35	0.42	0.19	0.46	0.36	0.12	0.42	0.25	0.61	0.38	1.00	
Global Bonds	-0.08	-0.03	-0.07	0.20	0.18	0.07	0.33	0.15	0.29	-0.08	0.03	-0.39	1.00

Source: SSGA Tuckerman Group

retail and leisure, and abundant business infrastructure. In Latin America (where 44% of the population, or approximately 220 million people, are under the age of 20), growth is occurring at its fastest pace in 10 years due to strong commodity prices, improved government policy, single-digit inflation, and free floating exchange rates. These macro trends are fueling demand for modern, high-quality real estate product throughout Latin America, including residential, office, industrial, retail and hotels.

Furthermore, the international real estate markets may provide attractive investment opportunities because they are less efficient than the U.S. market. For example, the scarcity of high-quality real estate in many rapidly growing international markets presents unique development opportunities for opportunistic and value-added real estate managers with the platforms and resources to identify, source, and execute. Additionally, while less than 25% of U.S. institutional real estate is owner-occupied, the majority of European and Asian corporations own their own real estate. We believe that global competition will continue to pressure these owners to consider sale and leaseback transactions to clean up their balance sheets.

In order to execute an effective international real estate investment strategy, investors must allocate significant capital and time to their due diligence efforts. Market transparency, currency issues, legal regulations, tax and cultural business practices present significant risks and complicate real estate investing overseas. For those investors who believe in the benefits but do not want to tackle these challenges, investment advisors may serve as a “one-stop-shop,” providing access to certain money managers.

Our belief is that every institutional real estate investment portfolio should have an allocation of at least 40% to value-added and opportunistic real estate and somewhere between 15% - 40% to international real estate depending on risk tolerance. Especially with the proliferation of capital, being diversified and carefully selecting the right managers represents a good strategy for pursuing top-quartile risk-adjusted real estate returns.

Allocating capital overseas may not only serve as a valuable diversification tool, but the international real estate markets present compelling structural, economic and demographic opportunities for growth. The implementation of the euro has eliminated 13 currencies and brought new liquidity and transparency to the market and has facilitated increased cross border investment. In Asia (which is poised to surpass the EU and challenge the U.S. in total output over the next 25 years), the growth in GDP per capita is creating a vibrant middle and upper income population, and drawing people to the cities. In China alone, an estimated 200 million people will move into urban cities to seek jobs over the next 10 years. The urbanization and new wealth is creating a need for better housing, increased

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## EQUITY MARKET OVERVIEW

# BULL RUN (STILL) AGING

by Michael A. Crowe

Senior Managing Director – Equity Management

In our second quarter 2006 commentary, we observed that the current bull run was approaching record length without a correction, but that a variety of indicators suggested that it would probably continue. Our biggest fear at the time was that we were “overdue” for a correction. It’s now another year later and the S&P 500 is up another 20%, leaving us pleased with the gain, but still harboring that nagging feeling that something has got to give.

In the intervening commentaries, we have noted several risks that could have, or even should have, broken the bull run. High energy prices could have crimped consumer spending, the housing slowdown could have hurt durable goods sales either through fewer new houses to furnish or less home equity to spend on grown up toys. The subprime meltdown could have triggered an overreaction or China’s stock market could have tanked. To varying degrees, these risks did come to pass and did have a negative effect on the equity markets, but not enough to offset the otherwise favorable conditions. 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.

On the positive side, all the elements of the classic macro-economic model are currently neutral to favorable for the equity markets. Unemployment is low enough to keep consumers spending, but not low enough to drive inflation. With inflation remaining low, interest rates have remained relatively low and steady. This has allowed consumers to keep spending, thus keeping earnings growing at a steady rate and P/E ratios at nominal levels. Also, as we have seen in the news every day, low rates have continued to fuel the private equity buyout binge.



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## HEDGE FUND MARKET OVERVIEW

# MARKETS REMAIN STRONG BUT CREDIT ISSUES ARE CAUSE FOR CONCERN

by Martin B. Kaplan

Chief Executive Officer – Advanced Strategies

In last quarter’s newsletter, we stated that global liquidity was the key driver of capital markets and that when this trend changes, we may revise our outlook. This quarter, although we saw a change in some of the key indicators we closely monitor, the major trends we typically discuss are still in place. Globally, non-U.S. economies continued to drive worldwide growth. In the U.S., consumer spending remained strong. Corporate profit growth climbed but at a slower pace than over previous quarters. Balance sheets remain strong and exhibit high levels of cash despite persistently robust share repurchases and dividend increases. Finally, U.S. economic growth slowed in the first and second quarter and, by some indicators, appears to be reaccelerating going into the third quarter.

As to the trends that started to change, credit markets are pricing higher perceived risk which is a departure from the behavior we saw during the past twelve months. With a tumultuous June, the second quarter saw credit spreads widen as worries about the sub-prime market flowed through to the collateralized debt obligation (CDO) and collateralized loan obligation (CLO) markets. Adding to credit market anxiety was the closing (or near closing) of several hedge funds, most notable the two hedge funds at Bear Stearns, that were invested in the sub-prime mortgage market. With lenders becoming more risk sensitive, the enthusiasm for funding riskier leveraged buyout transactions is abating somewhat although the funding appetite for higher quality LBOs appears to be intact. We are concerned that a significant slow-down in deal-making (which we do not anticipate in the near term) could cause trouble for equity markets as much of the current buoyancy in the U.S. market can be traced to the positive influences of corporate buyout activity.

While our outlook for the second half of the year is generally positive, our concerns are two fold. First, the U.S. economy poses a question. While most experts predict a rebound in the second half of the year, we are not entirely convinced this will happen. Our second concern is the state of global liquidity. Our view is that the sub-prime market will significantly worsen before it gets better.

*continued on p. 6*

## FIXED INCOME MARKET OVERVIEW

# HOME SWEET LEVERED HOME

by Steven P. Luetger

Senior Managing Director – Fixed Income Management

It is easy to look back at the underwriting standards of the mortgage market over the last few years and conclude that the subprime market was an accident waiting to happen. After all, an environment whereby a borrower could obtain a loan without providing proof of income or employment was one that was ripe for abuse. Making matters worse, subprime mortgage issuance was approaching 40% of the entire market, home prices were peaking, homebuyers were allowed to borrow most of their down payment and many investors in this product were liberally using leverage. Now, with interest rates having risen to five-year highs, subprime borrowers are facing higher monthly payments. Predictably, foreclosures on homes have been rising and there is no reason to expect them to stabilize or decline in the near future.

Lenders, in general, are tightening their underwriting standards or exiting the business all together, reducing the demand for housing. As home foreclosures continue to climb, the supply of homes for sale is expected to increase. Until this market reaches equilibrium, we expect the Fed to maintain its current 5.25% Funds rate.

The yield curve steepened modestly during the second quarter as the two-year Treasury yield jumped 28 basis points while the yield on the ten-year Treasury increased almost 38 basis points. While the spread between these two Treasuries ended the period at 16 basis points, the shape of the curve is still very flat. The bond market's total return, as measured by the Lehman Aggregate index, fell 0.52%.

As the market for subprime mortgages came under pressure during the second quarter, so did the market for other asset classes, particularly conventional mortgage-backed and commercial mortgage-backed securities. These sectors, as measured by Lehman Brothers, declined 0.50% and 1.05%, respectively, underperforming duration neutral Treasuries by 56 and 44 basis points. While leveraged buyout activity continues to cast a long shadow over the credit market, this sector performed surprisingly well in relative terms despite a nominal return of -0.73%. Credit modestly outperformed Treasuries by 4 basis points.

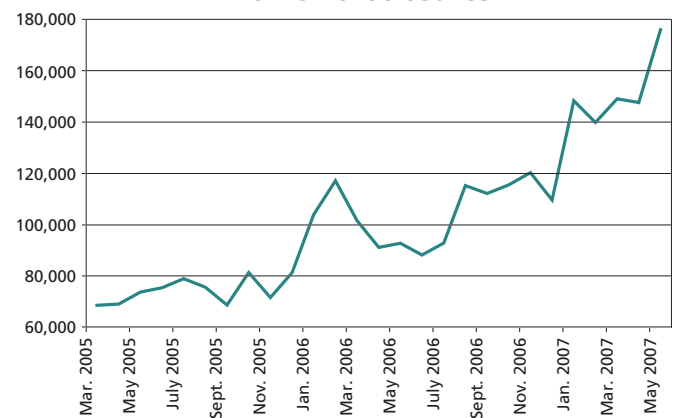
### Currency Market Overview, *cont'd from p. 1*

1.5% against the USD. Only the yen among the major trading partner currencies weakened against the dollar, by 4%.

Despite the overall USD weakness, the quarter was not a one-way trend. Early in the quarter, cautionary hints from the Federal Reserve about growing inflation threats sent the 10-year bond up to 5.25%, and the USD strengthened with it. By mid-June, however, continued soft economic data reassured markets and the dollar selling resumed.

The USD was under severe pressure as the quarter came to a close. Most currency counterparts were hovering near significant highs, again with the exception of the yen. While a quick and brutal retracement is possible if not likely, it seems the underlying trend is set to continue.

### Home Foreclosures



Source: Bloomberg

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

Over the past several weeks, there has been a noticeable shift in the debt markets as private equity firms have crowded the forward calendar with an estimated \$300 billion of planned financings. Confronted with this influx of supply and wary of spillover from the subprime mortgage meltdown, debt investors appear to be holding the line on leverage multiples and pushing back on certain borrower-friendly structures. Recent examples include the difficult financings for ServiceMaster, Thomson Learning, Dollar General and U.S. Foodservice, each of which needed to rely on a bridge loan from the underwriters to fill in for unsold debt.

In particular, debt investors have begun to resist two features which have become almost commonplace in large buyout transactions: pay-in-kind toggle notes (which allow borrowers to pay interest in more paper instead of cash) and covenant-lite deals (which reduce or effectively eliminate protective financial covenants to lenders). Based on recent market experience, we expect these terms to feature less prominently in future buyout transactions.

The question remains whether we are witnessing a temporary cooling of an overheated credit market or a more serious sustained pull-back. Clearly the credit markets have propped up buyout returns over recent periods, but at the expense of appreciably higher asset prices for new investments. According to *Venture Economics*, buyout funds generated pooled returns of over 24.2% in 2006, versus a 15.8% total return for the S&P 500. We believe that these recent returns are unsustainable and view a moderate correction in the credit market as a healthy step toward lower risk capital structures, more reasonable asset prices and a more controlled investment pace by buyout sponsors.

**COMPANY NEWS**

**MESIROW FINANCIAL LOOKS TO LONDON**

Mesirow Financial recently announced plans to open an office in London, England. Scheduled to open in late summer, the office will initially be staffed by senior research professionals from Advanced Strategies, the firm's hedge fund of funds group. The U.K. office further expands our global presence and enables us to better serve the European and Asian hedge fund managers who make up a significant percentage of our hedge fund investment portfolios. This expansion also lays the groundwork for other Mesirow Financial Investment Management businesses, such as Currency Management, to follow suit.

**FIRM EXPANDS INTO COMPENSATION STRATEGIES BUSINESS**

The leadership team at Mesirow Financial recently recognized an opportunity to expand services to corporate clients by partnering with a team we have trusted as our own executive compensation and nonqualified benefit plan consultant for the past eight years. The Giles Organization is now Mesirow Financial Compensation Strategies, a leading executive compensation team with a respected client roster. Based in Bannockburn, Ill., the group administers more than \$150 million in benefit plan liabilities for 2,000 participants in a variety of industries. The principal of The Giles Organization, Gregory P. Giles, is now president of the new group, Mesirow Financial Compensation Strategies, and a senior managing director of the firm.

**MESIROW FINANCIAL CELEBRATES 70TH ANNIVERSARY**

This year marks Mesirow Financial's 70th year of serving clients. On June 17, 1937, Norman Mesirow purchased a seat on the New York stock exchange, beginning our long history as a private, independent financial services firm. Originally called Mesirow and Company, that one-man securities brokerage has grown over the years both organically and through strategic acquisitions. Today, Mesirow Financial is comprised of more than 1,200 employees in 29 locations across the country, including Puerto Rico. Our professionals are organized into six main divisions, offering products and services to individuals, corporations, institutional investors and public sector entities, as well as broker/dealers and investment advisors. Yet, throughout our 70 years, we have remained staunchly independent and maintained our focus on delivering customized solutions in a highly personalized manner.

**EQUITY MANAGEMENT**

**EQUITY TEAM ADDS TWO NEW JUNIOR ANALYSTS**

Michael O'Brien and Kristan Rowland both recently joined the Equity Management team as junior equity analysts for the small and micro cap value investment strategies. These new team members add valuable additional perspective to our investment team, deepening our existing equity research capabilities.

Michael joins us from ABN AMRO/Lasalle Bank, where he provided trustee services for collateralized loan obligations.

Previously he worked for nine years as a pediatrician. Michael received a BS from the University of Notre Dame, an MD from Northwestern University's Feinberg School of Medicine, and an MBA from the University of Chicago. He has passed the CFA Level I Exam.

With nearly ten years of experience as an equity analyst, Kristan was most recently at Morningstar, Inc. Previously she worked at William Blair and Company as a research analyst. Kristan received a BA from the University of Notre Dame and an MBA from the University of Chicago Graduate School of Business. She has passed the CFA Level I and Level II Exams.

**CURRENCY MANAGEMENT**

**ZEHFUSS, STAMBAUGH AND POKORNY PROMOTED**

Mesirow Financial Currency Management is pleased to announce the promotion of three individuals who have made significant contributions to the growth and management of our business.

- Michael Zehfuss, head of business development, was promoted to managing director.
- Fred Stambaugh, head of portfolio management, was promoted to managing director.
- Barbara Pokorny, business development, was promoted to vice president.

In addition, the team welcomes Cristy Carbone, administrative associate. Cristy will focus primarily on client support and reports directly to Gary Klopfenstein, senior managing director and head of the Currency group.

**COMMODITIES MANAGEMENT**

**ALTERNATIVE MANAGEMENT BUSINESS EXPANDS WITH NEW CAPABILITIES IN COMMODITIES**



Willis, Sr.



Willis, Jr.

Mesirow Financial Investment Management continues to expand its capabilities in alternative asset classes. A year ago, we launched our Commodities Management group, which offers innovative investment alternatives, ranging from long-only index linked solutions to low volatility total return strategies. A growing interest in this area has led us to expand the group by adding two seasoned commodities professionals: Thomas C. Willis and Thomas R. Willis. Founding principals of Willis Trading Group, LLC, a Chicago-based commodity trading advisor, the two add breadth and depth of experience to the existing commodities team, led by Sean Harte, managing director.

How this trouble will flow through and impact the rest of the credit markets will require attention in the coming months.

In sum, we see changes to the sanguine environment observed over the past twelve months. We view the apparent reduction in risk appetite by market participants to be healthy. This trend is currently creating short opportunities in the structured credit markets (e.g., shorting the credit of LBOs as well as the firms that structure and finance them) and, in limited cases, the equity markets. As the marketplace works out some of the current excesses over the longer term, we expect renewed opportunities both on the long and short sides of the market.

## PRIVATE EQUITY

### PRIVATE EQUITY CLOSES MODSPACE AND CORADIANT INVESTMENTS

Mesirow Financial Private Equity, Inc. (MFPE) recently completed direct co-investments in Modular Space Corporation (ModSpace) and Coradant, Inc. In the ModSpace transaction, MFPE helped finance the acquisition of General Electric's modular space business by Resun Holdings, a Calera Partners portfolio company. ModSpace is a leading provider of modular space solutions to the government, education, commercial and healthcare markets. MFPE also led a new round of venture financing for Coradant, joining an investment syndicate that includes Doll Capital Management. Coradant is a leader in the "real user monitoring" market, enabling the delivery of consistent online application performance.

## VALUE-ADDED CORNER

*Mesirow Financial offers institutions a wide range of products and services that extend beyond our Investment Management offerings. Each quarter, this section presents a case study from one of these areas to demonstrate other ways we can bring value to our relationship with you. This quarter we highlight how our Structured Settlements professionals helped a large hospital to settle a large medical malpractice claim and reduce the overall cost of the payout.*



### Structured Settlements Professionals Structured Cash and Annuity Package That Reduced Demand By Approximately \$330,000

#### CHALLENGE

Our client, a large hospital, had to settle a large medical malpractice claim that needed to fit within their budget. The plaintiff's attorney made a final demand of cash and structured settlement benefits totaling \$2.2 million. The proposed structure was \$7,500.00 per month, with a 10-year guarantee for life at a compounded interest rate of 6%.

#### ACTION

Our structured settlement specialist advised the plaintiff's attorney that our client as well as the carrier would probably not agree to those terms and recommended that we may be able to find a solution that funded the same cash and structure for under \$2 million. We went back to the child's treating physicians for a current medical report which was presented to several markets in an effort to increase their rated age mortality assumption. We found one carrier, who after receiving the medical report, moved 10 years on their rated age (from 70 to 80).

#### RESULT

Mesirow Financial Structured Settlements was able to provide the same settlement cash and structure that previously cost \$2.2 million (which the insurer never would have paid) for a revised cost of \$1,870,000. By working with current medicals and underwriters at various life insurance companies, we were able to reduce the cost of the benefits by \$330,000, which fit into the hospital/insurer's settlement budget.

The scenario presented is applicable to the individuals and or entities depicted and may not be representative of the experience of others. There is no special consideration given to the client in the scenario and it may not be indicative of future performance or success.

## CONTACT US

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