

CHESWOLD LANE ASSET MANAGEMENT, LLC

100 FRONT STREET, SUITE 960
WEST CONSHOHOCKEN, PA 19428
PHONE 610-940-5330 FAX 610-941-5009

INTERNATIONAL HIGH DIVIDEND STRATEGY

3RD QUARTER 2007 INVESTMENT LETTER

Thank you for your continued interest in Cheswold Lane's international value equity strategy. During the 3rd quarter 2007, our investment strategy composite returned 3.38% on a gross basis compared with a rise of 2.18% in the MSCI EAFE (Morgan Stanley Capital International Europe, Australasia and Far East Index) including income, net of withholding taxes and expressed in US dollars. Year to date, our investment strategy composite has returned 14.27% on a gross basis compared with an increase of 13.15% in the MSCI EAFE Index.

Market Review & Outlook – 3Q 2007

The 3rd quarter of 2007 witnessed extremely volatile conditions in the global equity markets, particularly in the financial sector. In last quarter's investment letter, we highlighted the change in tone of the US sub-prime mortgage market *with the bailout and subsequent wipeout of two Bear Stearns' hedge funds*. The "tone" did indeed get progressively worse. By late August credit fears had engulfed debt markets across the globe. Liquidity quickly became the focus, as debt markets seized up in panic and hysteria. Short term wholesale-funded businesses like Countrywide and Northern Rock rapidly became distressed situations. For more than a week major European banks refused to lend to each other, as they collectively hoarded liquidity. The voracious risk appetite that helped fuel global asset appreciation over the last 3-4 years simply evaporated – replaced with extreme risk aversion. Bank of America, eventually, came to Countrywide's rescue and the Bank of England stepped in to be the lender of last resort for Northern Rock. However, it was the Federal Reserve's 50 basis point cut in both the Fed Funds and Discount Rates which proved to be the pivotal catalyst for the late September rally in global equities.

It's clear that the global economy is slowing and the US, especially the US consumer, is leading the decline. European growth remains intact for now, but higher interest rates, the stronger Euro and mixed business confidence polls have made European stock markets less sanguine. In Japan, recent GDP figures have softened due to weak domestic demand and sluggish sales to the US consumer. Adding to the complexity of the situation for central bankers is the rise of inflation. Increases in wage and commodity inflation are making it more difficult to achieve the preferred balance of low inflation and moderate-to-strong economic growth. In some ways, we think market participants should feel lucky that the Federal Reserve's last meeting was September 18th, and not October 18th; because we doubt Chairman Bernanke could have cut rates 50 basis points considering the strong US jobs report issued on October 5th.

In our opinion, the period of low nominal and real interest rates, which fueled a significant portion of this economic cycle's growth, is over. Credit spreads have started the mean reversion process. Areas of excess in the economy such as housing, construction, retail, autos and investment banking are going through their own corrective phases as well. As the global economy slows, corporate revenue growth will slow and profit margins will contract. We expect quality businesses with strong and stable cash flows, modest capital requirements, prudent balance sheet leverage and reasonable valuations to outperform in this environment.

Portfolio Review – 3rd Quarter

Cheswold Lane's portfolio benefited from strong performance in the technology, telecom and utility sectors; leading performers in these sectors were Nokia, France Telecom and the German utility, RWE. The financials sector was the primary performance detractor for the quarter (Barclays, Societe Generale, Fukuoka Financial). The portfolio's underweight in basic materials continued to hinder performance, however, strong stock selection (BHP and Sumitomo Chemical) offset most of the negative effect. Overall, attribution for the portfolio was well balanced between stock and sector selection. The portfolio continues to have a large to mega capitalization bias versus the index and our peers. This is primarily a function of the valuation disparities between small and large capitalization stocks. Small cap stocks underperformed large cap stocks during the 3rd quarter, carrying on the trend experienced in the 2nd quarter. We would expect this to continue as the global economy shifts to a lower level of sustainable growth.

During the quarter, we increased the portfolio's weight in basic materials, and modestly, in industrials and technology. Financials and consumer discretionary stocks were reduced. Our recent additions in basic materials (JSR Corp, Nitto Denko, Sumitomo Chemical) are focused primarily in the electronic materials sub-sector; an area of the Japanese stock market hit hard in the last 12 months by the downturn in the semiconductor and liquid crystal display (LCD) industries. These are quality businesses experiencing a cyclical trough and trading at attractive valuations. Positions eliminated during the quarter include: Barratt Development, Persimmon, Groupe Danone, DNB NOR, Fukuoka Financial, Mitsui Trust, and Bank of Kyoto. New positions were initiated in: ENI, Alfa Laval, Schneider Electric, Hoya, Nitto Denko, Sumitomo Chemical, Telefonica SA, and Voestalpine. The portfolio's largest overweight sectors are telecom, consumer staples and energy. The largest underweight sector continues to be industrials, followed by consumer discretionary and now, financials. Our country allocations have not changed significantly. We remain overweight continental Europe, particularly Norway, modestly underweight the UK, and underweight Asia, which is predominantly Japan. We have no foreign exchange hedges or cross hedges in place.

While certainly a volatile quarter, overall we were pleased with the performance of the portfolio. However, we expect market turbulence to persist until the debt markets regain confidence and the global economic picture for 2008 clears.

Best regards,

Colleen Quinn Scharpf
Eric Scharpf
Matt Taylor

THE VIEW FROM CHESWOLD LANE...

Kicking the Tires on the International Investment Road

I spent much of September on the road in both Asia and Europe meeting with corporate executives, government officials, academics and other institutional investors. The most interesting part of my travels was spent in Tokyo, where I attended a major investment conference focused on Japanese equities, the economy and government policies.

Admittedly, Cheswold Lane's investment discipline has certain challenges to overcome with respect to investing in Japan. To review, our investment universe is the top 3 quintiles of dividend yield in the MSCI-EAFE index. Our multi-factor model ranks these stocks based on valuation, return on invested capital (ROIC), and to a lesser extent, momentum. The stocks are then segmented into their respective sectors so that we can focus our fundamental research on the highest ranked stocks by sector. We concentrate, generally, on the top 200-250 ranked stocks.

In Japan, the first, and most obvious, challenge is the rather paltry level of dividend yields – in fact Japan has the lowest yield of any country within the MSCI EAFE index. Although this is an issue, it's not too concerning as there are still a large number of Japanese stocks which achieve our dividend yield hurdle. The second challenge is valuation. Japanese stocks are the most expensive stocks in our universe, based on P/E ratios. However, much of the difference between Japanese P/E's and European or US P/E's is related to differences in accounting and tax policies. This lowers the "reported earnings" of Japanese companies. The more appropriate valuation metric is related to cash flow, not earnings. Cheswold Lane's primary valuation metric is Firm Value to EBITDA (earnings before interest, taxes, depreciation and amortization). In this respect, we are striving to achieve comparable accounting results of companies across geographic borders. On a cash flow basis, Japanese stocks are much closer in valuation to European and other developed market countries. They are modestly more expensive, on average, but there are a large number of Japanese companies to research with the same or even lower cash flow multiples than their European counterparts. This leads us to the real issue for Japanese stocks within Cheswold Lane's investment framework – low ROIC. Even if one adjusts the returns for differences in inflation rates, Japanese companies have significantly lower ROIC than other companies in the EAFE index. This is the largest factor depressing the relative rankings of many Japanese stocks in our investment universe.

So, why travel to Tokyo? It was an opportunity to meet with management of Japanese companies currently in our portfolio and to be exposed to new investment ideas. More importantly, it was a chance to gain a better understanding of the probabilities of *real* change in Japan. Some of the barriers to improving ROIC in Japan are structural, thus very difficult to change – such as the aging and shrinking population, but others are related to poor government and corporate policy which could change through reform. It sounds simple, but investors have been waiting for meaningful reform in Japan for a very long time. International portfolio managers even like to joke about the number of times Wall Street pundits and strategists have called the turn in the Japanese economy and stock market based on new reforms. It speaks volumes about the deeply ingrained cultural issues of a country which has suffered through 15 years of recession and still failed to create decisive reform policies. In fact the ruling party, the Liberal Democratic Party (LDP) has only been out of power once, briefly, in the last half-century.

While I've described "Japan" as a low dividend yield, relatively expensive and low ROIC market, this is a little disingenuous. To be fair, the Japanese corporate environment is more diverse. Most market participants divide Japanese companies into two basic groups – domestic-oriented and exporters. The former have consistently struggled due to extremely poor domestic economic conditions over the last 15 years. The domestic market is focused on market share *shifts* rather than category growth. This intense competition spurs innovation but doesn't increase overall growth or returns. Broadly speaking, I put the consumer discretionary and staples, utilities, telecommunications, financials, materials and real estate sectors in the "domestic-oriented" category. This group typifies my view of the average Japanese company – low dividend yield, relatively expensive, low ROIC; and generally a poor track record of earnings and dividend growth. However, robust government and corporate reform could meaningfully improve shareholder returns in these sectors.

The "exporters" are where most of Japan's best companies can be found. They include the autos, industrials, and technology sectors – the latter comprising of hardware, software, consumer electronics, semiconductor and electronic materials companies. The exporters have been able to compete in the international markets for growth. Many are global leaders such as Toyota, Canon, Komatsu, Nikon and Nintendo. They have better track records of growth and ROIC. Management of exporters tends to be more progressive than their domestic counterparts; many have adopted US-style organizational structures, behavior and practices. Corporate governance, especially related to shareholder issues, is also far superior in the exporters. The majority of Cheswold Lane's Japanese holdings come from this group. The limiting factor is usually valuation as opposed to low ROIC.

Recent Data Points From Tokyo

The Japanese stock market rocketed in the 2nd half of 2005, acting as a leading indicator that the domestic economy was set to improve in 2006 and beyond. Reform measures put in place by Prime Minister Junichiro Koizumi were well received by the market. However, the Japanese stock market stalled in 2006 and returns fell significantly behind those of Europe and the US. What changed? Prime Minister Koizumi's chosen successor, Shinzo Abe took control of the government in the 2nd half of 2006 and the market began to sense that reform policies were set to wane. Market returns in Japan have continued to lag Europe and the US in 2007.

Unfortunately, most of the data points I collected while in Japan were not encouraging – the most obvious being the abrupt resignation of Prime Minister Abe. It had been a very difficult summer for the Prime Minister. His approval rating, 70% when he took office, had plummeted to less than 20% due to a series of cabinet corruption scandals and his support of the Japanese Naval refueling program of US warplanes in Afghanistan. His party, the LDP, lost control of the upper house of parliament (similar to the US Senate) in late July. This turned out to be the final straw. Prime Minister Abe resigned during the second week of September.

The inside story is that Abe had made too many promises to LDP cronies in order to become Prime Minister. This severely limited his ability to institute new government reforms or even maintain former Prime Minister Koizumi's fiscal budget discipline. He was saddled with what had become a very unpopular military association with the US in Afghanistan. And while replacing the charismatic Koizumi would be difficult for any successor – the contrast between the two politicians was extreme. In fact, within days of Abe's resignation many local politicians in Japan were calling for Koizumi's return as Prime Minister. I was told that Koizumi turned down this opportunity. At the end September the LDP appointed Yasuo Fukuda the new Prime

Minister. His selection was considered neutral to modestly negative by the Japanese stock market. The fear is that the government will revert back to its old ways; increased spending on infrastructure projects and social welfare programs as opposed to balancing the budget, lowering taxes and instituting capital market and employment reforms.

The local discussion regarding Japanese monetary policy was not much better. The stock market wants the Japanese central bank, the BoJ, to increase interest rates again in the 4th quarter, thereby signaling their confidence in the economy. This would have the knock-on effect of increasing net interest margins for the Japanese banking sector and potentially fueling better domestic economic growth. However, with the US economy clearly slowing and the US consumer looking even worse, Japan, as a major exporter to the US, will likely see reduced demand in the near term. Considering the export companies are the only growing businesses in Japan, this is a real risk to the Japanese economy. Therefore, it's now viewed as "unlikely" that the BoJ would increase interest rates in the 4th quarter, which will be taken negatively by the market. The US Federal Reserve's 50 basis point cut has added to the political pressure on the BoJ to keep Japanese interest rates unchanged. Unlike the Federal Reserve, the BoJ is subject to significant political pressure from the Japanese government. It appears the US and Japan are in a race to see who can devalue their currencies faster in order to support their export economies. One potential take-away from the Japanese monetary situation is that investors will have a relatively strong margin of safety to buy the Japanese export companies during the periodic unwinding of the yen carry trade. Stocks like Toyota, Honda, Canon, Ricoh, Sony, etc... are sold coincidentally with the strengthening of the yen, which occurs when global markets become more risk averse. Hedge funds, currency speculators and some institutional investors de-lever during times of financial turmoil by selling assets in high interest rate countries like Australia and New Zealand and buying back liabilities in low interest rate countries, such as Japan. But in today's economic environment, the Japanese government wants to support its exporters by keeping the yen relatively weak versus its major trading partners – the US, Europe, China, Korea, and Singapore.

What does this mean for Cheswold Lane's clients?

Today, Japanese equities represent approximately 12% of our portfolio's assets; a significant percentage, but still less than our benchmark's 20% weight. However, this is simply an output of our sector-oriented research process. We continue to diligently look for new investment ideas in Japan. My confidence in the domestic Japanese economy is weak, but we'll continue to monitor the new government's policies. I expect our bias towards the Japanese exporters to remain. In fact, I can foresee an opportunity to buy more high quality export companies at attractive prices as the US consumer weakens into early 2008.

As always, we appreciate your support and welcome your thoughts and ideas.

Best regards,

Eric Scharpf
Portfolio Manager
Cheswold Lane International High Dividend Strategy