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## INTERNATIONAL HIGH DIVIDEND STRATEGY

### 2<sup>ND</sup> QUARTER 2007 INVESTMENT LETTER

Thank you for your continued interest in Cheswold Lane's international value equity strategy. During the 2<sup>nd</sup> quarter 2007, our investment strategy composite returned 6.86% on a gross basis compared with a rise of 6.40% 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 10.53% on a gross basis compared with an increase of 10.74% in the MSCI EAFE Index.

#### *Market Review & Outlook – 2Q 2007*

The second quarter of 2007 witnessed continued strong performance from global equities, especially emerging market and European stocks. The global economy shrugged off weak growth in the United States and continued to demonstrate above trend economic growth of 4+%. Emerging markets shares lead the global markets, increasing between 15-40% during the quarter. European developed market stocks advanced 4-8%, followed by the US +6% and Japan +5%. The US dollar continued its weakening trend versus most major currencies with the exception of the Japanese Yen. Of note, the Australian and New Zealand dollars hit 20-year highs versus the US dollar and the British Pound crossed the 2.00 USD/Pound level.

In this environment, global cyclicals – primarily industrials and basic materials, and especially metal and mining stocks continued to perform extremely well. However, unlike the 1<sup>st</sup> quarter 2007, energy stocks rallied strongly, as oil prices rose sharply due to robust gasoline demand and global refining capacity curtailments. Geopolitical concerns also bolstered the oil industry as prices rose just shy of 2006 highs. High prices have not curtailed demand enough to knock global oil supply/demand relations out of balance. In fact, intermediate and long term concerns about non-OPEC supply capacity are also supporting a higher current and short term futures price for oil. Healthcare stocks, especially large pharmaceutical stocks, continued to underperform the overall market. The US subprime lending fears of the 1<sup>st</sup> quarter have spread to European housing, low-

end retailing, consumer finance, investment banks and mortgage related banks and brokers.

As we enter the 2<sup>nd</sup> quarter earnings season, we have yet to see a break in the strength of global cyclicals. Earnings revisions remain very favorable for these sectors and recent M&A activity is supporting the group, as well (Rio Tinto/Alcan, BHP/Alcoa?). However, credit risk appetites appear to be waning and may have reached a plateau. The second wave of anxiety from the US subprime market demise has now been felt in the market with the bailout and subsequent wipeout of two Bear Stearns hedge funds. Additionally, private equity financing appears to have experienced its first setback, as banks, which offer bridge loan financing for LBO deals, are now openly talking about changing credit standards for new deals. And finally, it's not lost on us that Blackstone, Fortress, and KKR shares are all trading below their significantly oversubscribed IPO prices.

Higher interest rates continue to weigh on consumer spending as a significant percentage of global consumer debt is priced off of floating interest rates, such as Prime or Libor. The UK and Spain have been most affected by this trend in Europe, with investors looking to the US as a roadmap of what could potentially spread to Europe. The European Central Bank and the Bank of England both raised interest rates in the 2<sup>nd</sup> quarter and signaled further rate increases before year end. On an absolute level, interest rates in Europe are still below US rates, but the gap is narrowing quickly. The market consensus is for the Bank of Japan to tighten rates in the 3<sup>rd</sup> and potentially the 4<sup>th</sup> quarter. Japan's export economy continues to perform well, especially the capital goods area. Autos are slower, mostly due to their dependence on US consumers for growth. The weak Yen continues to provide significant support to Japanese exports, while demand from the Japanese consumer remains muted.

### *Portfolio Review - 2<sup>nd</sup> quarter*

Cheswold Lane's portfolio benefited from the strong performance of the energy sector as well as strong stock selection in telecommunications (Vodafone), technology (Nokia), utilities (E.ON) and consumer staples (Henkel, Unilever). The portfolio's underweight in industrials and basic materials continues to hinder performance. The financials and healthcare sectors also detracted from performance, although this was due to poor stock selection (Fukuoka Financial, GlaxoSmithKline, Eisai Pharma) rather than sector allocation. 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 2<sup>nd</sup> quarter – and we are very closely watching to see if this is the start of a trend.

During the quarter, we have increased the portfolio's weight in the consumer staples, telecommunications, consumer discretionary, and energy sectors. Healthcare and financials have been reduced. Positions eliminated during the quarter include: GlaxoSmithKline, AstraZeneca, Altana, Takefuji. Balancing these sales were new purchases in the financials, consumer staples, and materials sectors. New positions were initiated in: Bank of Ireland, Irish Life and Permanent, Groupe Danone, and JSR Corp (electronic chemicals). The portfolio's largest overweight sector is energy, followed by

telecom. The largest underweight sectors continue to be industrials and materials. 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.

Overall, we were pleased with the performance of the portfolio during a very challenging quarter for our style of investing.

Best regards,

Colleen Quinn Scharpf  
Eric Scharpf  
Matt Taylor

## THE VIEW FROM CHESWOLD LANE...

### ***The Big Picture – Europe Attempting to Improve Its Competitiveness***

In light of the recent strong performance of the international markets, US investors, especially those suffering from home market bias, are showing increased interest in the “big picture” case for Europe. Recently, an interesting article related to Europe’s economic growth disappointments of the last 15 years appeared in *The McKinsey Quarterly*, the strategy consultant’s research periodical. More importantly, the article also discussed how this could be changing. The article was written by a former McKinsey consultant from Frankfurt, Germany, Heino Fassbender, who has also just written a new book, *Europe as an Economic Powerhouse: How the Old Continent Is Gaining New Strength*.

In the article, Fassbender makes the case that the central culprit of Europe’s historical economic shortcomings has not been the European welfare state or globalization, but rather that “the real issue is the staggeringly large – 32 percent – per capita output gap between Europe and the US. The gap is mostly the consequence of Europe’s poor productivity over the past 10-15 years.” More specifically, low labor productivity, followed by low labor inputs has driven slower economic growth for the region versus the US. According to a 2002 McKinsey study, labor productivity in Europe varied significantly between countries and sectors; and while Europe was ahead of the US in some segments of retail and mobile telephony, it lagged in most other sectors including: automotive, road freight, banking, electric power generation, apparel/clothing and fixed line telecommunications.

Broadly speaking, Fassbender’s proposed solutions for the European governments were: (1) Create deeper structural change – meaning liberalizing markets so weak competitors are driven out of business by more innovative and productive ones; as well as creating a level playing field to encourage entrepreneurs to develop products and companies because they will be rewarded more equitably and quickly than in the past. (2) Develop a “smarter” regulatory system – focusing on better governance, clear purpose, appropriate design, effective implementation and expiration will help to create a more productive single market. (3) Renew focus on areas where Europe has comparative advantage – making the most of what Europe does best will drive better overall productivity and growth. (4) Reshape / Redefine the role of the State – changing the way Europe’s welfare state delivers public services, and channeling more resources into education and research.

It was an interesting article and very timely considering the recent government changes in the three major continental countries of Europe – the election of Romano Prodi of Italy, Angela Merkel of Germany and most recently, Nicholas Sarkozy of France. Its clear Europeans want more from their governments. They see the status quo not working and realize it will only get worse as their populations continue to age. Trading off pension benefits versus higher taxes on workers is an unenviable position, but highly likely, if the situation doesn’t change. In some areas, we are already seeing clear signs of change. For example, this year in Germany, the workers’ labor union at Volkswagen made major

work-rule concessions in order to improve productivity and thereby save jobs. More surprisingly, Nicholas Sarkozy ran against the Socialist party in France based on liberalizing work rules, including the elimination of the government-mandated 35 hour work week and a reduction of social costs corporations pay to layoff or fire employees. And yet, he won – easily.

Another significant area of change occurring in Europe is corporate taxes. Tax rates in Europe have historically been high. This was thought necessary to pay for the welfare state, but after watching the success of countries like Ireland and Poland, attracting new companies and hence, new jobs to their economies, many European politicians have promised to lower taxes to compete for jobs and spur economic growth. The German Upper House of Parliament just lowered corporate taxes from 39% to 29%. Nicolas Zarkosy also ran on the promise of corporate tax relief to improve France’s competitiveness versus other European countries.

***What does this mean for Cheswold Lane’s clients?***

What investors need to remember is that it is not the “absolute” that matters in the stock market, but rather it is the “relative change” that drives stocks. The US remains the world’s dominant economy, with the most global 500 companies operating in a historically pro-business environment. However, Europe is showing signs of positive change in its corporate and government policies, which could make Europe a better stock market for years to come. Admittedly, it is still early in the process for most major European countries, but well worth watching.

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

Best regards,

Eric Scharpf  
Portfolio Manager  
Cheswold Lane International High Dividend Strategy