Investment Briefing

CHOATE INVESTMENT ADVISORS

CHOATE

Why Bad News for a Company Can Be Good News for Your Portfolio

It's not easy going against the crowd when the financial media line up against a company because of a product recall, regulatory problems, or missed earnings estimate. Some people find it difficult to buy that company's stock; paradoxically, that may be the best time for the long-term investor to act.

A Great Company May Be A Bad Investment

Consider a company that's universally well-regarded and grows at a steady rate. It's a great company. But it may not be a great stock for a new investor if it is selling at a premium because all of the company's pluses are already reflected in its stock price. In an efficient market, a stock's current price should reflect the investing world's consensus view about its prospects. A very positive opinion of a company generally means that its stock price has less room to rise. Moreover, its price is often more vulnerable to any stumble. In other words, less upside but potentially significant downside.

On the other hand, once that great company is hurt by bad publicity, it might be priced attractively. Bad headlines often drive down stock prices. Many investors fail to anticipate that the future might be better than current headlines suggest. Yet these companies often rebound over the longer term. In fact, history has shown that investors typically generate better long-term returns when they make investments that go against consensus opinion.

We often find opportunities in stocks with bad news. But a cheap price is not enough by itself. We seek stocks for which we believe the price decline is temporary. In some cases, the bad news is only a blip in its good long-term performance. We try to differentiate between short-term problems that can temporarily depress a stock and more serious changes to a business model that can hurt a company's long-term outlook.

Why People Don't Buy Good Stocks at Reasonable Prices

If investing against the consensus is such a successful strategy, why doesn't that

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Why Bad News for a Company Can Be Good News for Your Portfolio

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strategy attract more investors? Too many people jump on the bandwagon to dump or avoid a stock hit by bad news. There are four main reasons they do this:

- **Influence of the media.** The financial media favor headlines that are black and white. Investors may be swayed to see a company's situation as bleaker than it really is.
- **Human nature.** It's easier to go with the crowd. Just think back to the Internet bubble of the late 1990s. It seemed as if most everyone piled into those overpriced stocks. We did not.
- **Professional investors' fear of career risk.** Some professionals figure that they are more likely to lose their job over a "contrarian" wrong call than over a wrong call also made by many of their industry peers. It's more conservative to buy popular stocks, just as computer buyers once said, "You can't go wrong buying IBM."
- **Focus on short-term investment returns**. Many investors pressure their portfolio managers for short-term results. In the short-term, investment returns are heavily influenced by consensus opinion. That deprives these managers of the advantage of investing for the long-term when a company's operating results are more likely to drive its stock price.

How Our Investment Approach Helps Your Portfolio

Our investment process helps us to overcome the inclination to blindly follow the consensus, thereby missing attractive opportunities. Instead, we focus on independently valuing companies based on our long-term outlook for their business. This emphasis is reinforced by our:

- Quantitative ranking system
- Valuation process
- Long-term focus

We differ from the many investors who simply follow their hunches to identify candidates for investment. They tend to search for information that confirms their preconceptions. We prefer to start with an objective, quantitative process that often challenges our preconceptions.

We rank stocks using quantitative data from multiple sources that we believe add value to the stock selection process. We use this quantitative ranking system, which we discussed in earlier Investment Briefings, to prioritize our analysts' research. Its objective measures of growth at a reasonable price drive our analysts to focus on the highest-ranking stocks as candidates for purchase and the lowest ranking stocks as candidates for sale. This typically results in non-consensus thinking because the highest ranking, most reasonably priced stocks have generally attained that status because of investors' worries. The reverse is true of low ranking stocks.

Of course, this ranking system is only the starting point of our process. Next comes the valuation process, when our analysts dig more deeply into the company's business. We use sophisticated models to create our own estimate of a company's worth. We create our own independent forecasts of sales, profit margins and other important variables, looking five years into the future. This frees us from Wall Street analysts' tendency to forecast the continuation of existing trends. We forecast changes in direction, when our research justifies them.

We can chart an independent course because we focus on your long-term success, instead of short-term investment gains. We strive to make this an integral part of our investment culture.

If you'd like to see an example of how we strive to capitalize on bad news to invest in a good stock, please feel free to contact one of our portfolio managers. We would be glad to review a specific example in a face-to-face meeting with you.

SECTOR FOCUS

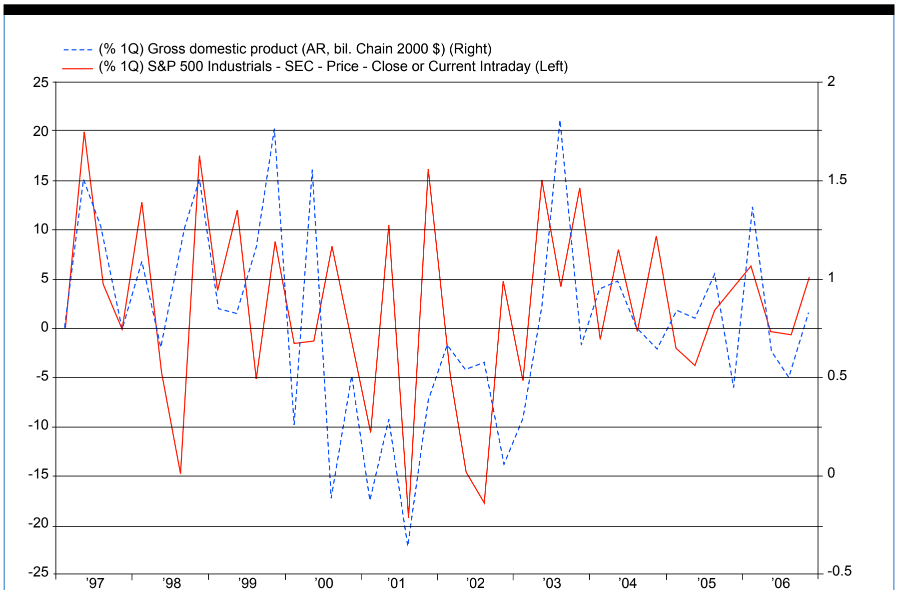
Industrials

It's important to hold the right industrial stocks at the right time. If the US is in the middle of the economic cycle, as some believe, then industrial stocks could continue to enjoy a nice run-up. If, as we believe, that's not the case and the US is in the economic cycle's late stages, then many industrial stocks are a riskier choice. If you're a typical Choate client, we believe your portfolio is well-positioned in industrial stocks that will out perform in the late stages of the economic cycle. That reflects our conservative, stock-by-stock selection process.

Challenge for Industrial Stocks

Generally speaking, industrial stock performance tends to reflect the state of the overall economy. That's because products and services offered by the industrial sector are important to making the economy run.

The chart below shows how stock prices in the industrial sector tend to rise as the economy grows, and then decline as the economy slows. The blue line depicts gross domestic product growth on a quarterly basis, while the red line represents industrial sector performance. Though it is not a perfect fit, the relationship between industrial stocks and the overall economy is quite clear.



Source: Factset

With the economy slowing, we believe it is appropriate that the Choate Investment Advisors' model portfolio was modestly underweighted in the industrials sector as the first quarter of 2007 ended. It's not that we make top-down decisions about sector weightings. Rather, these weightings are the result of many decisions about which individual stocks represent the best investment opportunities for our clients. Our stock selection process is also reflected in the identity of our specific holdings in the industrial sector.

Digging a bit deeper into the history of industrial stock performance, we see that lower quality, debt-heavy companies with a narrow product mix often make money hand over fist in the early stages of economic growth. Those same companies suffer as the economy slows. That's when more diversified and higher quality stocks typically fare well.

We believe that the economy is in the late stages of the economic cycle, given that we are entering the seventh consecutive year of economic growth. It's the phase of the cycle when defensive companies historically have outperformed their more aggressive counterparts.

The industrial stocks in Choate's model portfolio fall into the defensive camp. They also possess higher than average ranks in S&P's Quality Rankings. The historical record says that these higher rated stocks have outperformed over the long-term – especially during economic downturns. That is not surprising given their consistent record of earnings and dividend growth over decades.

Tapping Global Growth

We further believe that integrated industrials (companies with multiple product platforms and service offerings) are best poised to benefit from the global infrastructure expansion occurring in China, India, Eastern Europe and other emerging markets. We believe companies such as GE, 3M, United Technologies and Emerson Electric all

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Industrials

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possess the scale, intellectual capital, reputation and management acumen critical to forging sustainable business relationships around the world. All of these conglomerates play critical roles in the development of a country's infrastructure such as factories, roads, utilities, airports, etc.

The industrial companies in Choate's model portfolio should benefit from global expansion because they derive, on average, approximately 50% of revenues from international markets. For example, 60% of 3M's revenues come from international markets. In terms of scale, GE is one of a few companies worldwide that can afford to engage emerging market countries in the build out of their national infrastructures. Not only does GE participate in the development and construction of large projects, it is often also involved in financing them.

Avoiding Overexposure to Housing

There is much concern in the media today about the implications of a weaker housing market for the overall economy. None of the industrial stocks in Choate's model portfolio is heavily exposed to the housing sector when compared to industrial stocks that derive a majority of revenue from domestic end markets. However, United Technologies' Carrier Unit (air conditioning and commercial refrigeration division) will stand to benefit when housing stabilizes. Meanwhile, its other business units are benefiting from healthy global trends.

Some Benefit Despite Disappointing Capital Spending

Numerous companies overspent on capital projects prior to the recession that hit in 2001. During the recent economic recovery, companies have generated record amounts of cash resulting from impressive growth and more disciplined capital spending. What have they done with all this liquidity? Today, senior managers have placed a much stronger emphasis on increasing share buybacks and dividends.

Despite the fact that capital spending has recently been below expectations in the US, several pockets of industrial stocks have reaped rewards from accelerated capital expenditures. Industrial companies have benefited from expenditures on projects overseas, particularly infrastructure-related projects. For example, Emerson Electric, given its sophisticated process control and automation systems business, benefits from new factories being built abroad. Emerson's solutions act to monitor and control the work flow environment of factories and drive productivity gains in client manufacturing processes.

Company Focus: United Technologies

Recently our Industrials analyst attended the annual Lehman Brothers Industrial Select conference. There he heard from United Technologies CEO George David. Mr. David is one of the most respected corporate leaders and has led UTC's compounded annual growth rate in revenues of over 10% since 2000. UTC has benefited strongly from its Otis Elevator operations in foreign markets. This business is particularly attractive because once an elevator is installed in a building it invariably requires ongoing servicing. The profit margins are much higher in the servicing mix and the revenue streams are very consistent. The Otis Elevator business model is so famous that is has been featured in case studies at top MBA programs around the world.

Another prosperous business for UTC is its aerospace division. This segment is made up of Pratt & Whitney, Sikorsky and Hamilton Sundstrand. Pratt & Whitney manufactures aircraft engines for both commercial and military end markets. The fundamentals of the aerospace

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MARKET OVERVIEW

Housing Comes to the Forefront

The 416-point drop in the Dow Jones Industrial Average in late February reminded investors that what goes up can also come down. That particular decline was sparked by a huge one-day sell-off in the Chinese stock market. China quickly recovered. But the US market remained volatile on concerns about housing, especially subprime mortgages. The major US large-cap stock market indexes ended the quarter little changed from their levels as of December 31, 2006.

Shakeout in Subprime Mortgages

Many companies specializing in subprime mortgages went belly up recently. It's part of a housing market shakeout that we predicted (see Spring 2006 Investment Briefing), so we've avoided investing in companies focused on mortgages. As adjustable rate mortgages have re-set at higher interest rates in recent months, more and more homeowners with shaky financial situations have defaulted.

We believe more bad news is coming. For one thing, lenders have been lax in giving mortgages to borrowers with all sorts of credit records – not just the borrowers with poor credit histories who received subprime mortgages.

Homeowners hit by hefty interest rate hikes from re-set ARMs won't find it easy to refinance into cheaper loans. Lenders are tightening their standards for granting mortgages. Also, as housing prices fall, individuals who bought homes within the past year or so are likely to find themselves "under water." In other words, the current value of their property is less than the amount of their mortgage.

This credit crunch has a broader impact on the economy. It reduces demand for goods and services related to housing. Also, as individuals have less spare cash, it is likely to depress consumer spending.

Stock Market Volatility

In times of uncertainty, the stock market often swings up and down instead of moving forward in a straight line. That has been the market's pattern since late February.

It is unusual that the sell-offs have been very broad, with little divergence among asset classes. For example, large-cap, mid-cap and small-cap stock prices have fallen in tandem. It's possible that investors have sold their more liquid large-cap stocks to avoid selling their smaller, less liquid stocks.

As a result, high quality, low risk, large-cap companies continue to sell at lower multiples than riskier companies. For example, the trailing price-to-earnings ratio for the S&P 500 index is only 17x

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Market Statistics

	3/31/07	First Quarter Total Return	Last Twelve Months Total Return
Indices			
Dow Jones Ind. Avg.	12,354	-0.32%	13.78%
S&P 500 Index	1,421	0.64%	11.83%
NASDAQ Composite	2,422	0.44%	4.22%
Russell 2000 Index	801	1.94%	5.95%
Lehman US Treas. Int.	1,377	1.56%	5.63%
Interest Rates & Yields	**12/30/05**	**12/30/056**	**3/31/07**
Federal Funds Target	4.25%	5.25%	5.25%
10 Yr Treasury	4.40%	4.69%	4.66%
10 Yr Municipal	3.89%	3.79%	3.77%
S&P 500 Div. Yield	1.80%	1.86%	1.87%

MARKET OVERVIEW

Housing Comes to the Forefront

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earnings vs. 21x for the mid-cap index and 22x for the small-cap index. We believe that larger companies will perform well once investors decide they don't want to take as much risk in other asset classes.

In addition to reasonable stock price valuations, good news for the US stock market includes a healthy labor market and global economic growth. Although US economic growth has slowed, we remain on track for an economic "soft landing."

Please Contact Us with Questions

Although "Market Overview" focuses on short-term performance, please remember we do not manage your portfolio on a quarter-by-quarter basis. Instead, we keep our eyes focused on your long-term goals. We provide this quarterly commentary simply to help you understand the short-term fluctuations on your investment statements.

Please contact your trustee or Choate Investment Advisors portfolio manager if you have any questions about how these conditions affect your portfolio. Individual portfolios may vary considerably, depending on their goals and other circumstances.

Industrials

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sector have not been this strong in decades. According to another industry executive, "In my thirty-five years in the business, I have never seen trends this strong." It is clear that UTC is very well positioned to benefit from the very positive trends in aerospace.

Our Outlook for Industrial Stocks

Commensurate with our core investment philosophy of investing in highly profitable businesses selling for attractive valuations, we are optimistic that our industrial stocks are poised to benefit from continued global growth. Any moderation in growth domestically should be somewhat offset by strong international operations. Regardless of the short- term trends the domestic economy exhibits, we believe all of our industrial stocks possess sustainable competitive advantages that will drive profitable growth over both the near and long term.

If you have any comments about this newsletter, please feel free to email Doug Phillips at dphillips@choate.com.

GE, 3M, United Technologies and Emerson Electric are currently in the CIA model portfolio.
Certain CIA investment professionals own shares in GE, 3M, United Technologies and Emerson Electric.

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