October 2007

Quarterly Investment Perspective

Sizing Up Market Shifts

A Letter From Marc D. Stern, Chief Investment Officer

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5 **The Investment Roundtable: Credit Crunch**

Dear Client,

Who says bonds are dull? This year the fixed income markets have been the source of fireworks. Several years' worth of headlines were packed into the first nine months (Exhibit 1).

Exhibit 1: 2007 — Risk Gets Recognized

- Subprime problems hit ABX mortgage index (2/23)
- Major banks feel subprime fallout (3/13)
- UBS closes Dillon Read hedge fund unit (5/4)
- Moody's slashes credit ratings on subprime loans (6/18)
- Bear Stearns acknowledges two hedge funds are nearly worthless (7/18)
- Down 50% in one month, Sowood unwinds funds (7/31)
- Blaming lack of liquidity, BNP Paribas suspends fund redemptions (8/9)
- ECB and Federal Reserve inject liquidity into financial system (8/10)
- Hedge fund woes hit Goldman Sachs (8/14)
- Deutsche Bank refuses request for backup financing (8/15)
- Countrywide's woes multiply (8/16)
- Freezing of credit drives Fed's discount rate cut (8/17)
- Fed cuts rates by half a percentage point (9/18)
- Citigroup discloses deep wounds from subprime mortgage melee (10/2)
- A $5 billion bath at Merrill Lynch (10/6)

Source: Wall Street Journal

In our view, this turbulence stems from excesses building within the financial system over multiple years. Plentiful liquidity, lax lending standards, and exuberant borrowers helped create a period of extreme risk-taking ripe for reversal.

Just as abruptly as the turnaround occurred in July and August, investors seemed to breathe a sigh of relief in September and (at this writing) early October. In our view, though, it is premature to conclude that difficult market conditions are behind us. Weaker housing and tighter credit standards present challenges that will take more time to work through the financial system.

Nonetheless, we expect forecasts of a deep recession and bear stock market to miss the mark. The U.S. generates only about one-third of

worldwide economic activity, and we believe powerful global forces have taken on greater importance in recent years. Our research continues to uncover many interesting investment opportunities around the world, especially in equities and commodities.

Some Lasting Changes

Several of our senior investment professionals provide perspective on changing credit conditions in the Investment Roundtable on page 5. We will focus here on three notable implications of shifting markets:

Repricing of risk. Over the last few years, riskier assets performed best. Junk bonds beat Treasuries, riskier stocks outperformed blue chips, and newly built Las Vegas condos led the housing market. As a result, higher-quality assets had begun to appear unusually attractive relative to their riskier counterparts.

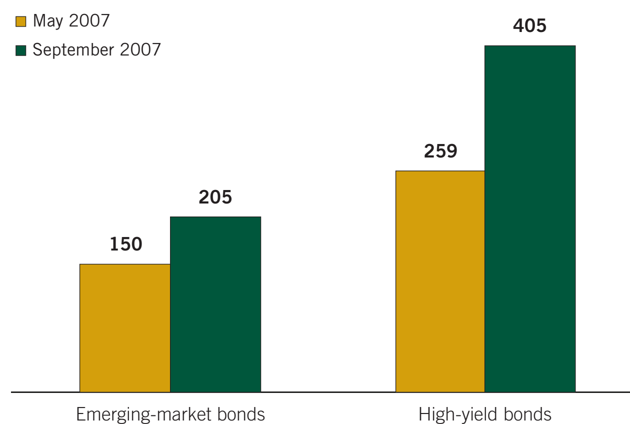
When mortgage-related troubles spread to the broader bond markets this summer, investors engaged in a classic flight to quality. Riskier securities, especially if their design made them difficult to evaluate, became nearly impossible to sell. Even certain well-regarded companies had difficulty obtaining short-term financing until these markets partially recovered late in the third quarter.

We foresee a more lasting change in the pricing of riskier securities in many asset classes. As recently as May, the extra yield available from emerging-market and high-yield bonds, for example, had compressed to unusually low levels. As investors began to demand additional compensation for taking additional risk, spreads widened dramatically in a short period (Exhibit 2).

These extra return figures have now moved closer to historical norms. As unwelcome as this development is for borrowers, it represents a favorable change for long-term investors seeking to earn returns commensurate with risk. A similar pattern appears to be developing in stocks, where investors are showing greater interest in higher-quality securities.

Exhibit 2: Wider Spreads

Extra Yield vs. Treasuries (in basis points)



Source: FactSet

More disciplined mergers and acquisitions. Easy credit fueled a buyout boom during the past few years. Sharp shifts in the credit markets have now crimped what had been described as a “golden era” of leveraged buyouts. We expect to see fewer mega-deals and heightened purchasing discipline. Most importantly, we anticipate far more lender discipline regarding the amount of leverage they grant to borrowers and the loan terms they insist on.

While the M&A market has cooled, we believe top-tier private equity firms with competitive advantages will continue to uncover attractive investment opportunities in the period ahead.

The end of housing speculation. Stress in the housing market has been building for some time. Unbridled enthusiasm led to excessive investment in residential construction, drawing capital away from more productive investment projects. We view recent drops in housing transactions and home prices as a healthy correction that is finally ending speculative activity.

Affordability measures — based on average incomes, average home prices, and prevailing mortgage rates — remain unusually low, suggesting that many potential buyers are still priced out of the market. The latest reading suggests housing affordability remains 13% below the 20-year historical average, and we expect challenges to persist in coming quarters.

Why No Recession?

Housing conditions have significant direct and indirect effects on the pace of overall economic activity. The housing market's strength helped on the way up, and its weakness will hurt on the way down. Our analysis suggests that U.S. real GDP growth would likely have come in at about 2½% in the second half of 2007, but housing troubles should cut this growth rate by about half.

To be sure, slower U.S. economic gains present challenges for economically sensitive companies and consumers. But it has been nearly 40 years since the last global recession, and we expect this streak to lengthen in the period ahead due to a variety of favorable fundamentals:

- Economic advancement continues in many parts of the world, including China, India, Russia, Eastern Europe, and Brazil;
- U.S. multinational corporations are well positioned to benefit, as reflected by sharp rises in net exports;
- Most corporations worldwide are in solid financial condition, with strong earnings gains enabling debt repayment, stock buybacks, and dividend increases;
- Increased corporate investment is boosting global job creation;
- Disposable income and household net worth have continued to rise;
- Attuned to the risks presented by housing weakness, central bankers in the U.S. and Europe have demonstrated willingness to take action to avoid a severe economic downturn.

An Inflationary Crisis?

History reveals that a pick-up in inflation brings great peril for investors. As a result, we always need to pay close attention to current and future price levels. Our strong advocacy of our Real Return Fund as part of a well-balanced asset allocation reflects this view.

Stimulative actions by U.S. and European central banks have raised concerns of an inflationary spike. Pessimists point to higher commodity prices as a leading indicator of trouble, and we see their point. But while we perceive longer-term inflationary threats — such as surging health care costs due to demographic shifts — we expect several forces to keep inflation relatively well-behaved in the near term.

The first factor is the Federal Reserve. Its monetary policy has withdrawn reserves from the financial system over the last two years, which has dampened inflationary forces. And even though the Fed cut rates in August and September, its commitment to controlling inflation remains intact; we believe the Fed stands ready to reverse its rate cuts if pricing pressures develop. Second, commercial banks' lending standards are tightening, which is reducing what economists call the "velocity" of money. Third, global investment in technology continues to boost corporate productivity, which holds down the need for companies to raise their prices. Finally, the world has become an extremely competitive place; globalization gives consumers more options, heightening their ability to source from the lowest-cost producer.

While stubborn price pressures persist, global inflation remains a manageable 2½%.

Investment Performance and Outlook

Our investment portfolios successfully navigated challenging markets in the third quarter. Our recommended Balanced Growth portfolios gained about 2½% for the three months, bringing our year-to-date return to approximately 9½% (Exhibit 3, page 4). These results outperformed our competition and the broad stock market.

Our focus is on outperforming in most portfolios most of the time. In that light, we are pleased to report we outpaced our benchmarks year-to-date through September in Real Return (+18.9%), Global Small Cap (+11.5%), U.S. Large Cap (+10.7%), and Fixed Income (+5.1%). Our Hedge Fund portfolios have also continued to deliver favorable returns at controlled risk levels. While our absolute returns in Mid Cap and International have been robust (each is up 9.5% year-to-date), we have trailed our benchmarks in these areas.

Exhibit 3: Performance Summary

	Third Quarter 2007	Year-to-Date 2007	Since January 2005 Annualized
Bessemer Balanced Growth[1]	**2.6%**	**9.3%**	**11.2%**
Lipper Balanced Average	2.1	8.1	9.5
Global Stock/Bond Index[2]	1.8	8.6	10.8
Bessemer Growth	**2.1%**	**10.2%**	**12.7%**
S&P 500 Index	2.0	9.1	10.8

As of September 30, 2007. Includes preliminary hedge fund returns, which are subject to revision.
2005 is the first full reporting period since Bessemer's Chief Investment Officer assumed responsibility for investments.
[1] The Balanced Growth Portfolio represents a model portfolio comprised of Large Cap, Mid Cap, International, Global Small Cap, Real Return, Fixed Income, and three Bessemer hedge funds of funds. The Growth Portfolio (previously called the Equity Portfolio) returns represent the performance of a model portfolio comprised of Large Cap, Mid Cap, International, Global Small Cap, Real Return, and two Bessemer hedge funds of funds. Investments cannot be made directly in these model portfolios. Relative weightings in the model portfolios vary over time. Returns for Old Westbury Global Small Cap Fund, Old Westbury Real Return Fund, and Bessemer hedge funds of funds are after all fees and expenses. All other returns reflect performance of Bessemer Common Trust Funds and are before fees and expenses. Past returns are not indicative of future performance. Index returns are before the deduction of fees and expenses. The index information is included to show the general trend in the securities markets during the periods indicated and is not intended to imply that the referenced portfolios are similar to the indexes either in composition or in volatility.
Old Westbury Global Small Cap Fund returns began April 5, 2005. Old Westbury Real Return Fund returns began April 28, 2005. Bessemer hedge funds of funds returns for this model portfolio began July 1, 2005, are preliminary and subject to revision. Alternative assets, including Bessemer hedge funds of funds, are not suitable for all clients and are available only to qualified investors.
[2] Global Stock/Bond Index reflects mix of S&P 500 (25%), S&P Mid Cap 400 (10%), MSCI EAFE (14%), MSCI World Small (5%), MSCI Emerging Markets (3%), HedgeFund.net (10%), Dow Jones-AIG Commodity Index (2.5%), Lehman Government/Credit (25%), Lehman TIPS (2.5%), and Treasury Bills (3%).
Source: HedgeFund.net, Lehman Brothers, Lipper, Standard & Poor's, Bessemer Trust

Bessemer's investment teams continue to focus on investments where underlying fundamentals suggest superior long-term return potential. At the same time, we believe it is especially important now for us to avoid "value traps." In these cases, valuations may appear compelling based on historical earnings for a particular company, but the likely future earnings power may shrink by enough to torpedo the investment potential. Many financial companies, including investment banks and commercial banks, may fit this category today.

We have viewed 2007 as a year where we could earn solid returns by investing in attractive securities within equities, hedge funds, and commodities. Our returns in these areas were substantial during the first nine months of this year.

Nonetheless, our concerns about investors' mispricing of risk led us to create a strategic cash reserve. This cash position has two benefits. First, it provides "dry powder" for us to invest in attractive asset classes — such as high-yield bonds, emerging markets, and convertible securities — at more compelling valuations. Second, our cash position arms us with an overall risk profile for our recommended allocations that enables us to remain fully invested in asset classes with superior long-term potential and generally reasonable valuations. We have sized our cash position to be large enough to provide a sufficient reserve for new investments, while being small enough so as not to jeopardize the overall return potential of our recommended allocations.

Market volatility in recent months has moved us closer to redeploying our strategic cash position. We look forward to providing details on changes to our recommended asset allocations in the coming months.

Sincerely,

Marc D. Stern
Chief Investment Officer

The Investment Roundtable: Credit Crunch

Daphne L. Bradshaw-Mack, Director of Hedge Fund Programs

Andrew M. Parker, Director of Quantitative Strategies

Lois R. Roman, Head of U.S. Equities

Marc de Saint Phalle, Director of Private Equity

Harold S. Woolley, Fixed Income Portfolio Manager

Tighter credit market conditions are rattling financial markets around the world. We asked several of our senior professionals to share their perspectives on the credit crunch and to discuss how it's affecting their respective investment arenas.

Q: What sparked the credit crunch?

Woolley: Subprime mortgages are at the epicenter of the global credit crunch.

Looser lending standards made homes more accessible to people unable to qualify for a standard mortgage. Adjustable-rate mortgages with attractive "teaser" rates made loans seem even more affordable to borrowers who might not have fully understood how high that rate could eventually go. Some lenders may have engaged in unscrupulous lending practices, helped by the proliferation of "no-doc" mortgages that raise the risk of borrowers overstating their creditworthiness.

Initially, delinquencies were unusually low because rising home prices made it possible for borrowers who had trouble meeting their loan payments to refinance. When the housing market weakened in 2006, this was no longer an option. As adjustable-mortgage rates reset higher, delinquencies spiked.

Q: So it sounds like the subprime problems deserve all the press they've been getting?

Woolley: Yes and no. It certainly is a significant issue. But by itself, it simply isn't large enough to constitute a broad economic crisis. After all, of the 110 million households in the U.S., only 7.5 million have a subprime mortgage. And even as delinquency rates rise, the majority of subprime mortgage borrowers will be able to make their payments on time going forward.

Q: So why did the subprime-mortgage meltdown turn into a broader credit crisis?

Parker: Two reasons. First, the credit market was vulnerable to disruptions because credit spreads (the incremental return earned for taking additional risk) had reached near-historic lows in a number of markets, including high-yield bonds and leveraged loans (used to finance buyouts). Surging subprime defaults caused investors to reassess risk broadly, leading to higher capital market volatility, wider credit spreads, tighter credit conditions, and stricter lending standards.

Second, investors worldwide discovered they had exposure to subprime mortgages through complex structured products. These instruments reached investors through a maze of interlocking avenues, raising the uncertainty about the location and magnitude of those risks.

Q: What are structured products and how do they work?

Parker: The innovation of structured finance, also known as securitization, began a few decades ago as a way to provide different groups of investors with the specific risk/reward characteristics they sought. Pools of assets — such as credit card receivables, auto loans, student loans, or mortgages — can be "sliced and diced" into distinct tranches (senior, mezzanine, and equity), each having a different priority claim on the cash flow from the underlying assets.

Senior tranches of asset-backed securities (ABSs) have the lowest risk because they have the priority

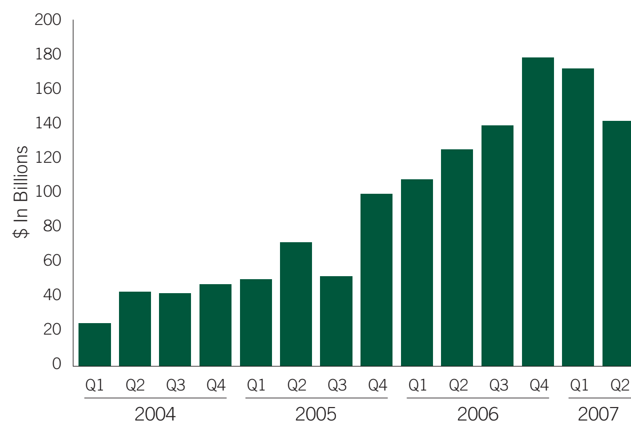
claim on the cash flow and they are the last to absorb losses if the underlying assets default. As a result, credit agencies gave many senior tranches triple-A ratings, on par with the highest quality corporate bonds, even for cash flows coming from risky subprime loans. Unrated equity tranches (equity is somewhat of a misnomer; also called junior subordinated notes) have the highest risk because they have the lowest priority claim on the cash flow and they are the first to absorb losses. To compensate equity-tranche investors for the higher risk, the potential returns are higher.

Collateralized debt obligations (CDOs) have become increasingly popular in recent years. CDOs are diverse portfolios of interest-bearing assets, such as asset-backed securities, corporate bonds, and bank loans. Here, too, different tranches of CDOs have varying claims on the cash flow.

Q: How widespread was the distribution of CDOs?

Parker: Extensive. The issuance of CDOs ballooned in recent years, rising from $25 billion in the first quarter of 2004 to as high as $177 billion in the fourth quarter of 2006 (Exhibit 4).

Exhibit 4: Global CDO Issuance



Source: Securities Industry and Financial Markets Association

Q: Who typically buys structured securities?

Parker: Yield-hungry investors around the world eagerly snatched up these assets despite their complexity and relatively low liquidity because they offered higher returns than traditional fixed income securities. The senior tranches lured conservative investors such as commercial banks, insurance companies, and pension funds. Hedge funds were also among the big buyers, with some managers accumulating large positions in the equity tranches.

This reflected a notable shift in how investors perceived risk. In earlier times, people would only buy a bond or lend money after carefully evaluating the credit risk to gauge whether the borrower was capable of repaying the debt. The advent of structured products created a gulf between the lender and the borrower. Ultimately, it became an issue of statistics.

Investors' voracious appetites for structured securities propped up the mortgage business chain — and for a while, everyone involved benefited handsomely.

Q: Who benefited?

Woolley: The first link in the chain was mortgage borrowers. As Wall Street demanded more and more mortgages, lenders lowered their standards to generate enough supply. As a result, potential borrowers who might not have received a mortgage under stricter standards were suddenly participating in the American dream of homeownership. The second link was mortgage originators, who sold the loans to commercial or investment banks, earning hefty fees. These banks, the third link, earned attractive returns by shifting the mortgage risks to investors via asset-backed securities and CDOs. For a while, investors benefited too, as they were getting what they were looking for: higher yields.

Q: Sounds like a well-oiled financial machine — what went wrong?

Woolley: As the underlying subprime loans deteriorated, credit agencies began to downgrade certain mortgage-related securities. Alarmed investors wondered if all asset-backed securities and CDOs were toxic. The complex nature of these instruments made it difficult for investors to price them appropriately, a problem that intensified as the market for them evaporated.

Two considerable weaknesses were exposed:

- **Lack of accountability.** Because financial institutions had less "skin in the game" after shifting much of the risk to investors, they had less incentive to lend wisely and cautiously.
- **Reliance on rating agencies.** The complexity of structured products meant investors relied heavily on rating agencies to gauge the risks. The agencies are now under fire for being too generous.

Parker: Leverage has magnified the associated losses. Some investment managers were borrowing significantly to boost their positions (and potential returns) in asset-backed securities and CDOs. As the value of the underlying securities declined, some managers were forced to liquidate their positions. While we suspect most highly rated asset-backed securities and CDOs will ultimately deliver promised returns to investors, the near-term turmoil has been powerful enough to sink some leveraged funds — as was the case with two Bear Stearns hedge funds.

Although unrelated to the subprime woes, another area that experienced problems this summer was leveraged hedge funds pursuing quantitative "market-neutral" strategies. For reasons that are not yet clear, many of these funds began deleveraging and selling down large equity positions. The fire-sale liquidation of similar portfolios led to erratic trades and wild price swings.

Woolley: As news headlines announced failing hedge funds, suspended fund redemptions, and refusals for backup financing by large banks, investors fled from riskier areas of the market into the safe haven of government bonds.

Q: This summer the commercial paper market had troubles. What happened?

Woolley: Normally, high-quality companies have no problems obtaining short-term financing through the commercial paper market. But the subprime mortgage debacle seeped into the commercial paper market through esoteric entities called conduits and structured investment vehicles (SIVs).

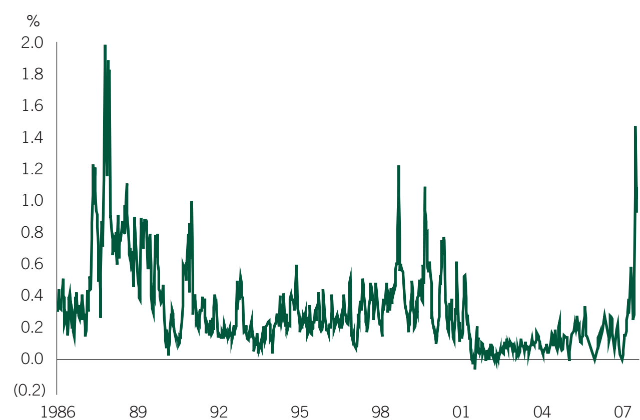
Roman: Banks set up these off-balance-sheet entities to hold assets such as mortgage-related securities. Using the assets as collateral, the conduit or SIV sells commercial paper to finance the purchase of more assets. Because commercial paper needs to be renewed frequently, many conduits have arrangements with the bank for backup financing if the conduit can't roll over its commercial paper. Banks profit from the difference between what the entity pays to short-term lenders and the yields it earns on the longer-term bonds it buys with the proceeds.

As credit troubles spread, major buyers — including pension funds, insurance companies, hedge funds, and money market funds — retrenched. The perils of using short-term debt to finance longer-term assets became clear.

Woolley: In the heat of the crisis, investors spurned nearly all asset-backed commercial paper, prompting a sharp widening in spreads (Exhibit 5). This triggered a surge in funding needs that nearly crippled the banking system in August. Some issuers of asset-backed commercial paper shocked the markets by exercising a clause allowing them to extend the maturity of the paper rather than redeem it when it came due. Jittery investors began withdrawing money from money market funds. In some cases, issuers requested emergency funding from banks. All of this pushed short-term interest rates higher.

Exhibit 5: Commercial Paper Spreads Widened

Extra Yield From Commercial Paper vs. Treasury Bills



As of September 30, 2007.
Source: Factset

Q: Have the actions of central banks contained the crisis?

Woolley: Yes, at least temporarily. Central bankers around the world took steps to add liquidity to their banking systems through open market operations. In the U.S., these actions came in three stages:

Offering repurchase agreements. The Federal Reserve offered to buy securities (such as treasuries, government agency, and mortgage-backed securities) from banks and broker-dealers and sell them back a few days later. These repo agreements decrease the financing needs of the banks from other sources, driving down the cost of borrowing.

Lowering the discount rate. In an unusual move, the Fed lowered the discount rate (the rate at which it will lend money directly to member banks) from 6.25% to 5.75%. This lowered the cost of funding for banks suddenly on the hook for providing backup financing.

Lowering the federal funds rate. In mid-September, the Fed lowered its target for the federal funds rate (the rate at which banks lend each other overnight reserve balances) by 50 basis points to 4.75%. In addition, they further reduced the discount rate to 5.25%.

Funding problems have eased considerably since then, but credit markets remain on edge. The commercial paper market has changed dramatically in a very short period, shrinking from $2.2 trillion in early August to just under $1.9 trillion as of this writing. Not all of the problems are behind us just yet. The subprime mortgage supply chain is still reeling from the setbacks, and we suspect we haven't heard the last of the bad news.

Q: Who has suffered losses?

Roman: Not surprisingly, among the shell-shocked are mortgage originators catering to subprime borrowers. So far this year, more than 50 lenders have filed for bankruptcy, including New Century Financial. The nation's largest mortgage lender, Countrywide Financial, is slowly shaking off the dire financing troubles it experienced this summer.

Financial institutions have complex and multilayered exposure to the subprime mess that will likely take time to unravel. Many large U.S. and European firms — such as Citigroup, UBS, Deutsche Bank, Goldman Sachs, Lehman Brothers, and Merrill Lynch — have recently announced plans to write down billions in assets, including securities tied to mortgages. Nevertheless, uncertainty remains about the full extent of potential losses. Because some banks may have hidden their exposure to mortgage-related asset-backed securities in conduits and SIVs, there is a risk that they will be forced to bring the assets back on their balance sheets. Many banks are working together to resolve these problems, including setting up a large consortium fund that will buy securities from SIVs. While this stopgap measure may help create an orderly and efficient market for SIVs in the short term, we suspect some longer-term problems remain. In addition to asset losses, we expect revenues of some banks will shrink as the market for structured products wanes.

Bradshaw-Mack: Certain hedge fund managers who invested heavily in mortgage-related structured products appear to have suffered substantial losses. In some cases, significant leverage exacerbated the problem.

Q: Does our hedge fund program have significant subprime exposure?

Bradshaw-Mack: While we have successfully invested in many different credit strategies through the years, including bank debt, high-yield bonds, distressed debt, and capital structure arbitrage, we have intentionally avoided managers whose sole focus is on highly leveraged structured-finance strategies. Within the subprime mortgage arena, we've actually been net beneficiaries of the deterioration, as several of our managers were positioned with short exposure in areas they felt were most vulnerable to repricing, including the subprime mortgage market.

We also try to identify managers who don't rely on significant amounts of leverage to drive returns. While leverage is a core part of certain strategies, such as fixed income arbitrage or convertible bond arbitrage, it is important to understand how much is being used and where it is being applied within a portfolio. While we may accept some leverage from these relative value strategies, they are one piece of an overall diversified portfolio.

In the end, we believe our investment philosophy of investing in hedge funds where the manager's skill, rather than leverage, drives returns allowed us to weather this difficult period. We seek to invest in managers who have a clear and repeatable process and investment discipline and are like-minded in their preservation of capital approach. While quantitative elements are a key component to their process, we are investing with individuals, not a black box. We focus on managers who use sound judgment and experience to navigate difficult market environments.

Q: How have our U.S. equity and bond portfolios held up?

Roman: Our U.S. equity portfolios have weathered the turbulence well. For some time, we have avoided riskier areas such as housing, mortgages, and REITs. Earlier this year, we began to underweight banks. Our emphasis on normalized earnings (a company's projected earnings power taking into account multi-year operating cycles) helped us identify and avoid banks that were over-earning our assessment of normal growth and were likely to experience slower growth as credit trends weakened.

Within the financial sector, even as our research has led us away from large commercial and investment banks that have been hardest hit by recent market turmoil, we have found select opportunities for our Large Cap portfolio in insurance stocks. In our Mid Cap portfolio, we are selectively investing in some regional banks that are insulated from the subprime fallout.

Our Large Cap portfolio is also benefiting from our emphasis on leading large growth companies. While we do not have a style bias, the current landscape favors large-cap growth stocks, which are ripe for outperformance versus mid- and small-cap stocks following a long period of underperformance. This reversal got underway earlier this year, and we expect this trend will continue as investors seek the relative safety of established companies with a global reach.

Woolley: In our Fixed Income portfolio, we have benefited from having very little credit exposure. In August, we had less than 1% of our portfolio invested in corporate bonds compared to 33% for the Lehman Brothers Government/Credit Total Index. We remain focused on quality by investing nearly the entire portfolio in government securities. Our research suggests that constructing a portfolio of intermediate-term securities is the best way to maximize returns at this time.

Q: Is the market turmoil opening up new opportunities?

Roman: Absolutely. As the stock market swooned and rallied during the past few months, undisciplined trading gripped many stocks — regardless of a company's connection to the subprime debacle. We viewed the market disorder with sober minds, staying with stocks in which we had strong conviction and focusing our attention on capturing investment opportunities as they emerged.

Particularly interesting to us were beaten-down stocks with a strong fundamental outlook that are unscathed by subprime troubles. Good examples of this are engineering and construction stocks. We had the fortitude to increase our positions as prices were falling because our research suggests these companies are in the midst of a multi-year growth cycle fueled by increased capital spending. As fear works itself out of the market, prices are now rebounding.

Another area we are watching closely is the consumer discretionary sector. A weaker housing market and elevated energy prices are likely to curtail consumer

spending, but some of these stocks are trading at valuations reflecting worst-case scenarios. We are adding to our holdings of companies with growth profiles that we believe will remain intact despite the difficult period ahead, while exiting positions in companies whose outlook has deteriorated.

As we search for attractive investment opportunities, we are cautious of "value traps." Sometimes prices fall for a good reason. In our opinion, banks had been over-earning on a multi-year cycle and their near-term outlook has soured as liquidity drains from the market. Lower prices are not enough to entice us back into bank stocks just yet. However, we are monitoring the situation closely.

Bradshaw-Mack: There are many opportunities on the table for skillful hedge fund managers. On the long side, areas of interest include "hung" bridge loans, senior bank debt, risk arbitrage, and oversold value equity investments. Our managers have been selectively participating in these opportunities.

Q: How are tighter credit conditions affecting buyouts?

de Saint Phalle: After five consecutive years of record investment in buyouts, it appears that the private equity investment cycle has peaked. The availability of capital — both equity and debt — enabled private equity firms to pursue increasingly large corporate divestitures and public-to-private transactions.

During the frenzy, banks served largely as intermediaries, underwriting loans to get M&A deals done and then selling those loans off in the form of collateralized loan obligations (CLOs). Many hedge funds, dedicated CLO funds, pension funds, and other institutional investors enthusiastically bought the CLOs. Banks charged fees for placing the debt and, more importantly, for providing M&A advisory services related to the transactions.

The loans to finance buyouts increasingly lacked an interest rate risk premium and became looser with respect to operating or financial restrictions on borrowers. In late 2005, we began to see "covenant-lite" loans, which were light on the typical financial maintenance covenants that set maximum leverage and minimum interest coverage requirements. This trend evolved through 2006 with the advent of "covenant-free" loans, and in 2007 with the introduction of "PIK-toggle" loans (pay-in-kind toggle loans) that allowed borrowers to miss cash payments on interest payable by increasing the principal due on the loans.

Amid the market turmoil this summer, CLO funds — which represented up to two-thirds of demand for the leveraged loan securities — began to balk at proposed offerings. With over $300 billion in loans to be financed on transactions announced prior to August, banks are scrambling to find investors.

Roman: This has raised additional concern about the outlook for some banks that had already committed to providing financing for buyouts. Market conditions may force banks to take the loans on their balance sheets rather than parcel them out to investors as planned. As this is sorted out, capital will be tied up and credit exposure will remain abnormally high at some banks, at least temporarily.

de Saint Phalle: Banks are working with buyout firms to try to restructure the loans in order to make them more palatable to investors. However, many of the proposed changes — such as higher interest rates, more restrictive maintenance covenants, and lower leverage ratios — would make the acquisitions less profitable for buyout funds.

As buyout firms rely on their lenders and vice versa, the players have shown some willingness, albeit at times grudgingly, to work out scenarios with acceptable solutions involving trade-offs. An example of this is the HD Supply transaction. The consortium of buyout firms, their syndicate of lenders, and Home Depot (the seller) were able to structure a revised acquisition and financing plan to complete the deal. A handful of other transactions have closed recently,

including First Data and Archstone-Smith; other deals have failed, including Harman and Acxiom; and many others remain pending, including Bell Canada, TXU, Alltel, Clear Channel, and Sallie Mae. The pending transactions are each over $25 billion in size, which demonstrates how current credit conditions appear to be having the greatest impact on the mega-buyout market.

In addition, investment firms are raising a number of credit opportunities funds, also known as vulture funds, to purchase bank loans and other M&A-related credit securities. This should help to clear the clogged up leveraged loan market.

Q: How has your outlook for the buyout market changed?

de Saint Phalle: Recent events, while troubling in the short term, have improved our long-term outlook for buyouts. We expect several positive developments to emerge:

Activity levels will normalize. We anticipate a three- to six-month lull in new deal activity as players concentrate on the current pipeline of previously announced deals. Private equity firms, which are having yet another record-breaking year in terms of commitments, will eventually look for new places to put their money to work. As they do so, we suspect managers will move away from mega-deals in favor of midrange deals, which we believe are more attractive. They are also more likely to pursue operationally intensive deals and transactions in new markets and geographies.

Greater purchasing discipline. The euphoria that can lead to ill-considered deals has dissipated. We expect purchasing price multiples to compress and debt levels to decline. Interest coverage ratios — the amount of free cash flow a company has available to pay scheduled interest payments — will also likely rise.

Greater lender discipline. In future transactions, we anticipate far more lender discipline regarding leverage and loan terms.

Return of strategic buyers. Strategic corporate buyers will likely become more active again. As private equity firms flexed their muscles in recent years, corporate buyers' share of the global M&A market has dropped from about 95% in 2000 to roughly 70% in the first half of 2007, according to Thomson Financial. The return of strategic buyers, while providing some competition to buyout firms in the short run, could also open the door in the longer term to more partnerships with financial sponsors. We recently saw this in the proposed acquisition of 3Com by Bain Capital and Huawei and the acquisition of Archstone-Smith by Tishman Speyer and Lehman Brothers.

Roman: The changed outlook for the M&A market has implications for the stock market as well. The buyout boom raised valuations of many companies — particularly within the mid-cap arena — that investors suspected of being takeout targets. In recent weeks, we have seen these premiums disappear.

Q: How are Bessemer's private equity programs positioned?

de Saint Phalle: For some time, we have been underweighting buyouts in favor of venture capital, relative to our peers. Within the buyout market, we have underweighted the mega-market, preferring instead to emphasize middle-market buyouts and growth capital where we see more of an opportunity to generate long-term value. The exposure that we do have to the mega-market is through some of our most highly experienced and successful managers. We have seen leading businesses with world-class management teams partnering with financial sponsors to jointly take advantage of specific opportunities to add value. While recent market turbulence may affect some of our existing investments, our overall outlook for our mega-market exposure remains positive. Indeed, many of the companies in our managers' portfolios have already generated demonstrable improvements in revenues, earnings, and free cash flow.

A critical aspect of our approach is focusing on managers who bring operational value-added to the companies in their portfolio. We believe disciplined, highly experienced, and skilled managers will likely outperform in the more challenging period ahead.

Q: Is there a key lesson from the credit crisis?

Woolley: Yes. The last few months reemphasize the importance of not relying solely on a grade assigned by a rating agency. These firms do important work, but simply seeing a grade of AAA or A or BBB doesn't tell the investor everything he or she needs to know about how the security will be affected by various potential market developments.

In addition, investors now have a greater appreciation of how credit risk can ricochet around the world. Innovative structured products and the forces of globalization have given investors access to investment opportunities in nearly every corner of the globe. This means a broader set of investors shoulder the accompanying risks, which is not necessarily bad. The subprime problems — while felt worldwide — will not likely be calamitous for any one group. Two years from now, the subprime debacle will be just one episode within a long history of up and down markets.

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