

STANDARD & POOR'S

S&P 500: BUYBACKS AND TREASURY SHARES THE OVERLOOKED AND HIDDEN ASSETS

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- The cash build-up remains high and is due to record earnings and commitment-shy management.
- The first major use of cash started in Q4 2004 for buybacks, and through Q1 2007 expenditures are in excess of \$965 billion.
- The record \$432 billion in buybacks in 2006 resulted in 56.8% of the issues reducing their share count.
- The impact of buybacks boosted EPS by at least 4% for more than 20% of the issues in 2006.
- S&P 500 treasury shares increased 19.7% in 2006; the share count reduction of 1.53% is the first decline in at least 10 years; the diluted share count was down 1.90%.
- **The market value of S&P 500 treasury shares is \$590 billion higher than their balance sheet posting, and represents 12.4% of the current market value.**
- **The buybacks and reduction in share liquidity puts upward short-term pressure on stock prices.**
- The cash and current market value of treasury shares represent the largest and most overlooked asset. How management utilizes this asset will likely determine corporate profitability and will impact the markets for years.

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THE GROWTH AND USE OF CASH

Cash and equivalents (cash) are classified under current assets on the balance sheet, and represent the readily available discretionary liquid assets of a company. Cash is measured for the S&P Industrials (Old), which consist of the S&P 500 minus Financials, Utilities and Transportation issues, since these issues maintain high cash reserves as part of their normal operating process [Note: The S&P Industrials (Old) date back for decades. When the GICS classifications were developed, one of the new sectors was the Industrials, so the former group is referred to as the S&P Industrials (Old)].

Over the past seven years, cash has grown to a record size, with its proportion of market value growing to levels not seen in almost two decades. **The cash build-up was the result of 18 consecutive quarters of double-digit earnings growth, combined with commitment-shy managements that pulled back on M&A, capital expenditures, expansion and new investments after the bear market of 2000-2002.** As investor demand grew for total return and for companies to maximize shareholder return, corporations started to initiate and increase dividend payments. Starting with the Microsoft initiation in January 2003, companies have steadily increased their dividend payments. This marked a reversal of a 20-year slide in the number of issues paying a cash dividend. The increase was substantial at the time, but as a percentage of As-Reported earnings, it continued to decrease. In the fourth quarter of 2004, the first major use of the built-up cash started in the form of increased buybacks. **The increased buyback levels were unique in that the additional shares were not being used for options or M&A, but rather were being put into corporate treasuries, creating share count reduction (SCR).** SCR was an uncommon event in the S&P 500, with most companies tending to increase their share counts through M&A over time and neutralize exercised options via buybacks (or at least minimize their impact on EPS). The aggregate value of buybacks continued to grow, as did the number of companies participating. Over the ten quarters between Q4 2004 and Q1 2007, S&P 500 issues spent \$965 billion on buybacks, slightly less than the \$1,010 billion spent on capital expenditures, and substantially more than the \$534 billion paid in the form of common dividends. In 2006, S&P 500 companies spend more on buybacks (\$432 billion) than the United States government spent on Medicare (\$408 billion). Buybacks during the first quarter of 2007

were \$118 billion, a record that may soon fall. During the second quarter, International Business Machines announced an accelerated repurchase of \$12.5 billion, while Home Depot authorized a \$22.5 billion repurchase program (\$12 billion being financed) and Wal-Mart authorized \$15 billion. The third quarter has also started off strong with authorizations of \$15 billion from ConocoPhillips and \$10 billion from Johnson & Johnson, and General Electric increasing its buyback program to \$14 billion. In addition, there are currently three Dutch auctions in the market (Dominion Resources, Home Depot and Charles Schwab) totaling over \$17 billion. In the short run, buybacks are a win-win situations for shareholders. They answer demands for companies to utilize their cash, add directly to shareholder equity, support the stock (even if it is in decline), and increase comparative earnings-per-share numbers in the same quarter the repurchase is made. From a management prospective, buybacks permit companies to maintain control and ownership over shares. Unlike a cash dividend that is distributed and cannot be recalled, these shares have not been retired, but sit in the corporate treasury, where they can be reissued (subject to regulatory timing) at the discretion of the company. The shares, while dormant when held in the corporate treasury, represent a growing asset in the marketplace that can be used for M&A, as well as defensive measures in the case of an unwanted offer.

THE CURRENT IMPACT

In the first half of 2007, significant cumulative buybacks reached an unprecedented level of acceptance by investors and continued their material impact on earnings per share. In year-over-year comparisons, 101 issues (over 20% of the S&P 500) reduced their Q1 2007 actual shares by at least 4%, and 72 issues reduced their average diluted shares (which are used to determine EPS) by at least 4%. This meant that at least 4% of their growth was attributed to SCR, rather than operating earnings. While the use of discretionary cash for SCR is a legitimate function of management, investors were, and remain, unaccustomed to looking for the variance, and not all companies highlighted the EPS impact. **As a result, P/E and growth evaluations that were not adjusted for the SCR effect reflected a higher premium paid for operating earnings.**

While the dollar value of buybacks has increased over the year, market prices have gone up quicker. The result is that the same buyback dollars spent today buy 20% fewer shares; that means the EPS impact is 20% less. If companies want the same ‘bang’ for their EPS growth rates, they will need to significantly increase buyback expenditures.

SIMPLE ILLUSTRATION OF SHARE CHANGE IMPACT ON EPS

10% increase in aggregate earnings, with reduced, the same, and increased share count

	Q2 2006 REPORTED	Q2 2007 IF SHARES DECREASED 4%	Q2 2007 IF SHARES THE SAME	Q2 2007 IF SHARES INCREASED 4%
Net income (millions)	\$100	\$110	\$110	\$110
Average shares (millions)	100	96	100	104
EPS	\$1.000	\$1.146	\$1.100	\$1.058
Year-over-year net income growth		10.00%	10.00%	10.00%
Year-over-year EPS growth		14.58%	10.00%	5.77%
Growth due to share reduction		4.58%	0.00%	-4.23%

LIQUIDITY

Up to now there has been little attention given to the liquidity aspect of buybacks. S&P adjusts the S&P 500 index shares on a quarterly basis, or inter-quarterly if there is at least a 5% change in shares. Inter-quarterly adjustments done solely for repurchased shares amounted to \$20.5 billion in 2006; for the first half of 2007 it was \$25.1 billion. The June 2007 quarterly rebalancing saw reduced share counts for 192 issues, increases for 132, and 176 left unchanged. The net result was that \$99.6 billion in market value was reallocated and the overall S&P 500 market value was reduced by \$67.8 billion. For the trailing year, rebalancing and the pure repurchase adjustments reduced the index market value by 2.4%.

S&P 500 INDEX RECENT SHARE CHANGES ASSOCIATED WITH REPURCHASES

Affiliated Computer Svcs	-16.58%
Compuware Corp	-7.95%
Constellation Brands	-8.70%
Countrywide Financial Corp	-6.22%
International Business Machines	-9.27%
Linear Technology	-15.19%
Macy's (formerly Fed Dept Strs)	-12.48%
Valero Energy	-9.12%
Wendy's International	-9.40%

There are now two related growing concerns regarding buybacks. First, companies lump dividends and buybacks together as a return of shareholder value, but dividend growth has been reduced as buybacks have continued to grow. **The second is that the reduced supply of open market shares could create a short-term price upturn, especially where individuals have cumulatively surrendered large numbers of shares via (direct and indirect) tenders.** From the start of the buyback bonanza in Q4 2004, 57.4% of the issues have reduced their share counts and 38.4% have reduced them by at least 4%. This compares to prior similar period when 37.0% reduced their shares and 14.0% reduced them by at least 4%. For the current membership of the S&P 500, common shares declined by 1.53% in fiscal 2006, the first reduction in at least 10 years. If M&A activity of AT&T, Boston Scientific and Procter & Gamble were excluded, the reduction would have been 2.79%.

HIDDEN ASSETS

Consistent with the values and history, these repurchased shares remain in corporate treasuries and have not been retired. The value of these shares is held at cost in the equity section of the balance sheet; there is no mark-to-market adjustment when they are internally held. Their actual day-to-day value varies with the market. Within the S&P 500, 338 issues were found to have treasury shares, with a cost basis of \$1,002 billion. If a mark-to-market adjustment were made, the issues would have had a market value of \$1,591 billion, representing 17.6% of their market value. If current (July 12, 2007) pricing were used, the value would have been \$1,708 billion, or 18.9% of market value.

The market value of the treasury shares, on aggregate for the entire S&P 500, now represents 12.4% of the company's market value and almost 38.4% of their long-term debt value. For the S&P Industrials (Old), the cash on hand combined with the treasury shares amounts to 21.0% of the market value.

For some issues, the difference between the cost and market value is significant. Within the S&P 500, 289 issues had a lower cost value than current market value, and 51 had a higher cost basis. If a mark-to-market evaluation were made, the higher value would have resulted in an increase to equity and a corresponding reduction in return values. Exxon-Mobil, which has reduced its share count for 27 quarters in a row, has a cost basis for treasury shares of \$83.4 billion, but their actual value is \$199.9 billion. Similar significant positive values can be found for Coca-Cola (\$22.1B cost vs. \$62.1B market), Altria Group (\$23.7B vs. \$50.3B) and Anheuser-Busch (\$16.0B vs. \$35.7B). Conversely, a small group of issues have a higher cost basis than their market value. Among those are Pfizer (\$46.7B vs. \$43.1B), Bristol-Myers Squibb (\$10.9B vs. \$6.3B) and Eastman Kodak (\$5.8B vs. \$2.9B).

WHERE DO WE GO FROM HERE?

The availability of this discretionary liquid asset, cash and treasury shares, makes almost every company a potential growth issue and many a potential take-over target. What companies choose to do with this enormous asset is perhaps the most important decision facing them, and it could have long-lasting effects as to their profitability and market value for years to come. Individual and institutional holders are increasingly demanding higher returns on their investments. While dividends have turned around and many companies have increased their dollar payouts, their payout ratios (dividends as a percentage of earnings) have declined. **Buybacks, while adding to short-term returns, are temporary in nature if the shares are not retired - which they have not been.** Cash build-ups that are now being used to supplement earnings via interest income and reduce share count are not a substitute for operating earnings and, as such, should not be priced into future earnings or multiples.

Investor demands, however, are not always reasonable. While companies may be hesitant if, in their evaluation they do not find the appropriate use for their

entrusted assets, it is far better for them to continue to hold the assets than invest them in a venture that they do not believe in. Investors, especially institutions, rightfully look at the opportunity cost, but often view them in retrospect, picking out only the rewarding ventures. A substantial number of mergers with high promised returns and synergies have proven to be improper investments.

Traditionally, excess cash and treasury shares were deemed to be a temporary situation that would be alleviated through corporate actions. However, the cash build-up has now gone on for years, and the treasury share value has impaired EPS comparisons. Both values have also grown to well beyond historical levels. Imbalances sometimes become the norm in the market, but given investor demands, recent market conditions and volatility, the necessity for corporate action seems to be mounting. Long-term the ability to do buybacks is limited both by the available cash reserves and by the upward pressure public markets can permit from reduced share liquidity and float. Long-term there are two alternatives. The first is a distribution, in the form of significantly higher dividends or a large, single, special dividend, similar in nature to Microsoft's. Companies, however, appear reluctant to give up their cash. With earnings and cash flow slowing, legitimate arguments to maintain excess reserves can be made. Similarly, while the retirement of the treasury shares would make permanent the EPS gains and increased shareholder value, it would remove management control and ownership. The second alternative is direct investment of both the cash and shares. Chief among these options is M&A, followed by expansion, capital expenditures, related venture capital investments and joint ventures. Public companies have been shy of M&A, which has reduced the competitiveness of deals and left the door open for private M&A. As earnings decline, we believe public companies will increase their M&A in order to quickly add revenue and earnings. Historically, the major reason for S&P 500 issues to be deleted from the index was acquisition by another S&P 500 issue. Current there are 17 public offerings for S&P 500 issues, with 12 of them being from private concerns and five from non-S&P 500 issue, all are for cash.

Regardless of the actions, any substantial use of the combined resources will likely have an impact on both the market and individual issues. Investors need to review management's history of applying these assets. **Given that we believe the greatest use of**

these assets (cash and treasury shares) will be for M&A, investors need to evaluate management's track record of not just picking target companies, but more importantly, of merging the two together. While the greatest single cost is in the association (acquisition, purchase or merger of equals), the true payoff comes in the ability to successfully meld the entities' employees, clients and processes. A seasoned and experienced management team can make even a misaligned deal pay off, while a poor one can ruin even the best of associations.

CASH BUILD-UP**STANDARD & POOR'S INDEX SERVICES****S&P 500 INDUSTRIAL (OLD) CASH AND EQUIVALENT LEVELS**

YEAR	CASH & EQUIVALENT BILLIONS	LTD BILLIONS	MARKET VALUE BILLIONS	CASH % OF LTD	CASH % OF MARKET VALUE
6/30/2007	\$603	\$1,520	\$10,214	39.67%	5.90%
2006	\$608	\$1,502	\$9,557	40.49%	6.36%
2005	\$633	\$1,539	\$8,546	41.15%	7.41%
2004	\$626	\$1,556	\$8,357	40.24%	7.49%
2003	\$500	\$1,292	\$7,633	38.69%	6.55%
2002	\$414	\$1,306	\$6,069	31.67%	6.81%
2001	\$352	\$1,327	\$8,161	26.55%	4.32%
2000	\$329	\$1,083	\$9,085	30.37%	3.62%
1999	\$261	\$981	\$10,291	26.57%	2.53%
1998	\$203	\$848	\$7,943	23.93%	2.55%
1997	\$169	\$791	\$5,597	21.35%	3.02%
1996	\$155	\$722	\$4,280	21.50%	3.63%
1995	\$135	\$670	\$3,484	20.14%	3.87%
1994	\$126	\$619	\$2,605	20.33%	4.83%
1993	\$115	\$599	\$2,505	19.24%	4.60%
1992	\$109	\$739	\$2,315	14.79%	4.72%
1991	\$105	\$637	\$2,215	16.45%	4.73%
1990	\$95	\$624	\$1,719	15.30%	5.55%
1989	\$98	\$565	\$1,816	17.41%	5.42%
1988	\$130	\$369	\$1,494	35.10%	8.67%
1987	\$138	\$343	\$1,393	40.14%	9.88%
1986	\$124	\$343	\$1,332	36.18%	9.33%
1985	\$105	\$315	\$1,181	33.29%	8.87%
1984	\$109	\$330	\$1,030	32.97%	10.55%
1983	\$97	\$293	\$1,048	33.13%	9.24%
1982	\$77	\$301	\$863	25.62%	8.94%
1981	\$75	\$266	\$734	28.01%	10.16%
1980	\$76	\$239	\$804	31.74%	9.44%

DIVIDEND PAYERS**STANDARD & POOR'S INDEX SERVICES
S&P 500 DIVIDEND PAYERS DATA**

YEAR END	ISSUES WITH INDICATED DIVIDEND RATES	% OF ISSUES	YEAR END	ISSUES WITH INDICATED DIVIDEND RATES	% OF ISSUES
6/2007	387	77.4	1993	435	87.0
2006	383	76.6	1992	436	87.2
2005	386	77.2	1991	434	86.8
2004	377	75.4	1990	438	87.6
2003	370	74.0	1989	437	87.4
2002	351	70.2	1988	432	86.4
2001	351	70.2	1987	429	85.8
2000	372	74.4	1986	426	85.2
1999	402	80.4	1985	442	88.4
1998	418	83.6	1984	446	89.2
1997	427	85.4	1983	454	90.8
1996	428	85.6	1982	458	91.6
1995	432	86.4	1981	462	92.4
1994	436	87.2	1980	469	93.8

DIVIDEND ACTIONS**STANDARD & POOR'S INDEX SERVICES
S&P 500 DIVIDEND ACTIONS FROM JANUARY 2003 - JUNE 2007**

SECTOR	ACTIONS	INCREASES	INITIATIONS	DECREASES	SUSPENSIONS
Consumer Discretionary	238	213	11	8	6
Consumer Staples	138	130	3	4	1
Energy	84	80	3	1	0
Financials	355	347	1	7	0
Health Care	80	72	4	2	2
Industrials	180	174	4	1	1
Information Technology	81	65	13	1	2
Materials	97	93	4	0	0
Telecommunications Services	25	21	2	2	0
Utilities	105	93	4	6	2
S&P 500	1383	1288	49	32	14
UNIQUE ISSUES	410	379	49	31	14

DIVIDEND PAYOUTS

STANDARD & POOR'S INDEX SERVICES

Estimates in bolded italics

QUARTER ENDING	AS REPORTED EPS	DIVIDEND PER SHARE	QUARTERLY PAYOUT	12-MONTH PAYOUT
06/30/2007	\$23.40	\$6.69	28.60%	30.27%
03/31/2007	\$21.33	\$6.52	30.58%	30.66%
12/31/2006	\$20.24	\$6.86	33.91%	30.53%
09/30/2006	\$21.47	\$6.09	28.36%	30.66%
06/30/2006	\$20.11	\$6.02	29.92%	31.46%
03/31/2006	\$19.69	\$5.91	30.03%	31.35%
12/30/2005	\$17.30	\$6.07	35.10%	31.81%
09/30/2005	\$17.39	\$5.43	31.24%	32.31%
06/30/2005	\$18.29	\$5.36	29.33%	33.08%
03/31/2005	\$16.85	\$5.35	31.72%	33.59%
12/31/2004	\$13.94	\$5.33	38.26%	33.20%
09/30/2004	\$14.18	\$4.88	34.43%	33.17%
06/30/2004	\$15.25	\$4.66	30.58%	33.13%
03/31/2004	\$15.18	\$4.56	30.04%	34.66%
12/31/2003	\$13.16	\$5.06	34.41%	35.67%
09/30/2003	\$12.56	\$4.32	34.41%	42.99%
06/30/2003	\$11.10	\$4.09	36.81%	46.79%
03/31/2003	\$11.92	\$3.92	32.90%	53.53%
12/31/2002	\$3.00	\$4.26	141.87%	58.27%
09/30/2002	\$8.53	\$3.90	45.73%	52.60%
06/30/2002	\$6.87	\$4.15	60.41%	59.99%
03/31/2002	\$9.19	\$3.77	41.02%	63.68%
12/31/2001	\$5.45	\$3.98	73.03%	63.75%
09/30/2001	\$5.23	\$4.14	79.16%	55.60%
06/30/2001	\$4.83	\$3.84	79.50%	42.65%
03/31/2001	\$9.18	\$3.78	41.18%	35.15%
12/31/2000	\$9.07	\$3.98	43.88%	32.54%
09/30/2000	\$13.71	\$4.09	29.83%	30.43%
06/30/2000	\$13.48	\$4.12	30.56%	32.16%
03/31/2000	\$13.74	\$4.08	29.69%	32.89%
12/31/1999	\$12.77	\$4.05	31.71%	34.65%
09/30/1999	\$11.93	\$4.45	37.30%	37.85%
06/30/1999	\$12.51	\$4.18	33.41%	40.10%
03/31/1999	\$10.96	\$4.01	36.59%	42.86%
12/31/1998	\$8.56	\$4.00	46.73%	42.96%
09/30/1998	\$8.99	\$4.26	47.39%	42.40%
06/30/1998	\$9.87	\$4.18	42.35%	40.93%
03/31/1998	\$10.29	\$3.76	36.54%	39.55%
12/31/1997	\$8.94	\$3.95	44.18%	39.00%
09/30/1997	\$9.87	\$4.06	41.13%	37.72%
06/30/1997	\$10.44	\$3.87	37.07%	37.39%
03/31/1997	\$10.47	\$3.61	34.48%	37.43%

BUYBACKS**STANDARD & POOR'S INDEX SERVICES**S&P 500, Values in billion, *estimates in bolded italics*

QUARTER END	MARKET VALUE	OPERATING EARNINGS	AS REPORTED EARNINGS	DIVIDENDS	BUYBACKS
06/30/2007	\$13,350	\$205	\$208	\$59	
03/31/2007	\$12,706	\$200	\$191	\$58	\$118
12/31/2006	\$12,729	\$197	\$182	\$62	\$105
09/30/2006	\$12,020	\$207	\$193	\$55	\$110
06/30/2006	\$11,497	\$199	\$182	\$54	\$117
03/31/2006	\$11,660	\$187	\$177	\$53	\$100
12/31/2005	\$11,255	\$182	\$156	\$55	\$104
09/30/2005	\$11,083	\$170	\$161	\$49	\$81
06/30/2005	\$10,890	\$178	\$167	\$49	\$81
03/31/2005	\$10,820	\$164	\$154	\$49	\$82
12/31/2004	\$11,289	\$167	\$130	\$50	\$66
09/30/2004	\$10,398	\$157	\$132	\$46	\$46
06/30/2004	\$10,623	\$158	\$142	\$43	\$42
03/31/2004	\$10,461	\$147	\$141	\$42	\$43
12/31/2003	\$10,286	\$138	\$122	\$47	\$39
09/30/2003	\$9,208	\$133	\$116	\$40	\$34
06/30/2003	\$9,001	\$119	\$103	\$38	\$28
03/31/2003	\$7,827	\$115	\$110	\$36	\$30
12/31/2002	\$8,107	\$110	\$28	\$39	\$31
09/30/2002	\$7,518	\$107	\$79	\$36	\$35
06/30/2002	\$9,091	\$107	\$63	\$38	\$31
03/31/2002	\$10,502	\$99	\$84	\$35	\$30
12/31/2001	\$10,463	\$91	\$50	\$36	\$33
09/30/2001	\$9,437	\$83	\$47	\$38	\$35
06/30/2001	\$11,027	\$81	\$44	\$35	\$34
03/31/2001	\$10,385	\$96	\$82	\$34	\$31
12/31/2000	\$11,715	\$116	\$80	\$35	\$34
09/30/2000	\$12,599	\$124	\$120	\$36	\$31
06/30/2000	\$12,484	\$128	\$116	\$35	\$37
03/31/2000	\$12,686	\$118	\$116	\$35	\$49
12/31/1999	\$12,315	\$115	\$107	\$34	\$45
09/30/1999	\$10,554	\$107	\$98	\$37	\$31
06/30/1999	\$11,232	\$108	\$102	\$34	\$32
03/31/1999	\$10,513	\$96	\$90	\$33	\$34
12/31/1998	\$9,942	\$93	\$69	\$32	\$32
09/30/1998	\$8,125	\$83	\$72	\$34	\$38
06/30/1998	\$8,956	\$90	\$78	\$33	\$29
03/31/1998	\$8,626	\$86	\$81	\$29	\$26

TREASURY SHARE BALANCES

STANDARD & POOR'S INDEX SERVICES
S&P 500 ISSUES WITH FULL TREASURY DATA

	VALUES IN MARKET MILLIONS	% OF MARKET VALUE
Cost of treasury less than market value - 338 issues		
Market value of companies	\$9,036,332	
Cost basis of treasury shares	\$1,002,352	11.09%
Market value of treasury shares	\$1,591,655	17.61%
Difference	\$589,303	6.52%
Current market value of treasury shares	\$1,708,270	18.90%
Difference	\$705,918	7.81%

TREASURY SHARE AND CASH BALANCES

STANDARD & POOR'S INDEX SERVICES
S&P INDUSTRIALS (OLD) ISSUES WITH FULL TREASURY AND CASH DATA

	VALUES IN MILLIONS	% OF MARKET VALUE
Cost of treasury less than market value - 244 issues		
Market value of companies	\$6,408,272	
Cost basis of treasury shares	\$825,823	12.89%
Market value of treasury shares	\$1,252,372	19.54%
Difference	\$426,549	6.66%
Cash	\$382,176	5.96%
Cash & market value of treasury	\$1,634,548	25.51%
Current market value of treasury shares	\$1,365,844	21.31%
Difference	\$540,021	8.43%
Cash & market value of treasury	\$1,748,020	27.28%

S&P DATA AND CLASSIFICATIONS

The data used in this report were compiled from Standard & Poor's Compustat and Stock Guide database, and are based on SEC filings. Data was as of the close of July 12, 2007. The constituents used consist of the current S&P 500 membership, and the data represent the latest compatible values. Data that do not conform, or were deemed incomplete for presentation, were not utilized. Additionally, individual issues that did not have complete data were omitted from the summary data. For this reason, some of the sum or variances of the data do may match the aggregates. The Standard & Poor's Index Services Group prepared this report, which is separate from the Standard & Poor's Credit Market Services Group (fixed income) and separate from Standard & Poor's Equity Research Services. This report does not discuss ratings or credit market aspects and does not make any buy/hold/sell recommendations for any securities.

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