

# STANDARD & POOR'S

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

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- Cash build-up of \$633 billion in S&P Industrials (Old) is due to record earnings and commitment-shy management.
- Initial use of cash resulted in dividend increases, but payout ratios continue to decrease.
- First major use of cash started in Q4 2004 for buybacks, and is now in excess of \$600 billion.
- The impact of buybacks has boosted EPS substantially for over half the issues.
- Interest income is expected to grow 60% and account for 1.6% of the 2006 projected 11.2% growth for the S&P Industrials (Old).
- **The market value of treasury shares is \$309 billion higher than their balance sheet posting, and represents 16% of their market value.**
- Cash and treasury shares for issues with both represent 25.6% of their market value.
- **The cash and current market value of treasury shares represent the largest and most over-looked asset. How management utilizes this asset will likely determine corporate profitability and 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 consists 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 five 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 16 consecutive quarters of double-digit earnings growth, combined with commitment-shy managements that pulled back on M&A, 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 levels were unique in that the additional shares were not being used for options or M&A, but rather were being put into the corporate treasury, 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 neutralizing exercised options via buybacks (or at least minimizing their impact on EPS). The aggregate value of buybacks continued to grow, as did the number of companies participating. Over the six quarters (between Q4 2004 and Q1 2006) S&P 500 issues spent \$515 billion in buybacks, compared to \$232 billion in the prior six quarters. In the short run, buybacks are 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 on a decline), and increase comparative earnings-per-share numbers. From a management prospective,

buybacks also 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 CURRENT IMPACT

In the first quarter of 2006, the level of significant cumulative buybacks reached an unprecedented level and had a material impact on earnings per share. In year-over-year comparisons, 108 issues (over 20% of the S&P 500) reduced their Q1 2006 average diluted shares (which are used to determine EPS) by at least 4% over Q1 2005. 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 not accustomed to looking for the variance and not all companies highlighted it. P/E and growth evaluations that were not adjusted for the SCR effect reflected too high of a premium for earnings that were not based on operating results.

S&P 500 SHARE YEAR-OVER-YEAR CHANGES	Q1 2006	Q4 2005
Issues reducing their actual shares	259	266
Issues reducing their average diluted shares	276	279
Issues reducing their actual shares by at least 4%	95	80
Issues reducing their average diluted shares by at least 4%	108	95
Interception at 4% reduction	83	64

### SIMPLE ILLUSTRATION OF SHARE CHANGE IMPACT ON EPS

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

	Q2 2005 REPORTED	Q2 2006 IF SHARES DECREASED 4%	Q2 2006 IF SHARES THE SAME	Q2 2006 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%
<b>Year-over-year EPS growth</b>		<b>14.58%</b>	<b>10.00%</b>	<b>5.77%</b>
Growth due to share reduction		4.58%	0.00%	-4.23%

Adding to the difficulties in properly evaluating earnings was interest income. **In 2005, interest income in the S&P Industrials (Old) was up 38%, and S&P estimates that due to the rise in interest rates, it will increase another 60% in 2006.** In a subset of the S&P Industrials (Old) with current P/Es between 8 and 35, S&P calculated the average P/E to be 18.4. However, when the effects of SCR and interest income were removed, the average P/E was 20.4. This variance is expected to grow, since buybacks are cumulative and continuing to increase, and interest income was increasing as companies more efficiently invested their cash reserves in higher interest-bearing accounts.

### **HIDDEN ASSETS**

Consistent with the values and history, these repurchased shares remain in corporate treasuries and are not 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, 273 issues were found to have treasury shares, with **225 of them having a lower cost basis (\$500 billion) than the prevailing market value (\$826 billion) and 48 having a higher cost basis (\$143 billion vs. \$112 billion).** If a mark-to-market adjustment were made, the issues with a lower cost would have resulted in a reduced equity value but a higher market share value for their treasury issues, while the 48 issues with a higher cost would increase their equity value but have their treasury share market value reduced. **In aggregate, the 254 issues with treasury and full data had a cost basis of \$702 billion and a market value of \$1,011 billion, with the \$309 billion difference creating a 44% variance.** The market value of the treasury shares represented 16% of the company's market value and almost 20% of their long-term debt. For a subset of the S&P Industrials (Old) with treasury shares held below market value and cash on hand, the combined value of both cash and treasury shares amounted to 27.6% of the market value. As a comparison, S&P 500 companies could totally fund their underfunded pensions (\$140B), underfunded OPEBs (\$321B), and pay all of the U.S. Medicare costs (\$355B) and still only reduce their cash and treasury share value by half.

For some issues, the difference between the cost and market value is significant. Exxon-Mobil, which has reduced its share count for 22 quarters in a row, has a cost basis for treasury shares of \$60.8 billion, but their actual value is \$119.8 billion. Similar significant positive values can be found for Coca-Cola (\$20B vs. \$48B), Altria Group (\$24B vs. \$51B) and Anheuser-Busch (\$16B vs. \$30B). Conversely, a small group of issues have a higher cost basis than their posted value. Chief among these are Bristol-Myers (\$11B vs. \$6B), IBM (\$41B vs. \$36) and Dell (\$20B vs. \$16B).

### WHERE DO WE GO FROM HERE?

**The availability of this discretionary liquid asset, both cash and treasury shares, makes almost every company a potential growth issue.** What companies choose to do with this enormous asset is perhaps the most important decision facing them, and could have long-lasting effects as to their profitability and market value for years to come. Individual and institutional holders are increasingly demanding a higher return 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 the short-term return, 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, are not a substitute for operating earnings, and as such cannot be priced into the stock.

**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 these in retrospect, picking out only the rewarding ventures. Substantial numbers 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. 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. 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.

Regardless of the actions, any substantial use of the combined resources will 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, 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**

<b>DATE</b>	<b>CASH &amp; EQUIVALENT BILLIONS</b>	<b>MARKET VALUE BILLIONS</b>	<b>CASH % OF MARKET VALUE</b>
6/30/2006	\$633	\$8,710	7.27%
2005	\$633	\$8,546	7.41%
2004	\$626	\$8,357	7.49%
2003	\$500	\$7,633	6.55%
2002	\$414	\$6,069	6.81%
2001	\$352	\$8,161	4.32%
2000	\$329	\$9,085	3.62%
1999	\$261	\$10,291	2.53%
1998	\$203	\$7,943	2.55%
1997	\$169	\$5,597	3.02%
1996	\$155	\$4,280	3.63%
1995	\$135	\$3,484	3.87%
1994	\$126	\$2,605	4.83%
1993	\$115	\$2,505	4.60%
1992	\$109	\$2,315	4.72%
1991	\$105	\$2,215	4.73%
1990	\$95	\$1,719	5.55%
1989	\$98	\$1,816	5.42%
1988	\$130	\$1,494	8.67%
1987	\$138	\$1,393	9.88%
1986	\$124	\$1,332	9.33%
1985	\$105	\$1,181	8.87%
1984	\$109	\$1,030	10.55%
1983	\$97	\$1,048	9.24%
1982	\$77	\$863	8.94%
1981	\$75	\$734	10.16%
1980	\$76	\$804	9.44%

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

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

**DIVIDEND ACTIONS****STANDARD & POOR'S INDEX SERVICES  
S&P 500 DIVIDEND ACTIONS FROM JANUARY 2003 - JUNE 2006**

<b>SECTOR</b>	<b>ACTIONS</b>	<b>INCREASES</b>	<b>INITIATIONS</b>	<b>DECREASES</b>	<b>SUSPENSIONS</b>
Consumer Discretionary	190	168	11	6	5
Consumer Staples	102	96	3	2	1
Energy	66	62	3	1	0
Financials	283	275	1	7	0
Health Care	62	56	4	2	0
Industrials	137	131	4	1	1
Information Technology	64	50	11	1	2
Materials	80	76	4	0	0
Telecommunications Services	20	18	1	1	0
Utilities	81	71	3	5	2
S&P 500	1085	1003	45	26	11
UNIQUE ISSUES	385	351	45	25	11

## DIVIDEND PAYOUTS

### STANDARD & POOR'S INDEX SERVICES S&P 500 DIVIDEND PAYOUT

*Estimates in bolded italics*

QUARTER ENDING	AS REPORTED EPS	DIVIDEND PER SHARE	QUARTERLY PAYOUT	12-MONTH PAYOUT
06/30/2006	<b>\$19.70</b>	\$6.02	<b>30.54%</b>	<b>31.63%</b>
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%
12/31/1996	\$9.86	\$3.79	38.44%	38.47%
09/30/1996	\$9.78	\$3.89	39.78%	40.72%
06/30/1996	\$10.13	\$3.77	37.22%	40.88%

**BUYBACK****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
06/30/2006	\$11,497	<b>\$192</b>	<b>\$178</b>	\$54	<b>\$95</b>
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 MILLIONS	% OF MARKET VALUE
<b>Cost of treasury less than market value - 225 issues</b>		
Market value of companies	\$5,426,215	
Cost basis of treasury shares	\$499,659	9.21%
Market value of treasury shares	\$826,186	15.23%
Difference	\$326,528	6.02%
<b>Cost of treasury shares more than market value - 48 issues</b>		
Market value of issues	\$852,259	
Cost basis of treasury shares	\$143,386	16.82%
Market value of treasury shares	\$112,130	13.16%
Difference	-\$31,256	-3.67%
<b>Issues with full treasury data - 273 issues</b>		
Market value of issues	\$6,278,475	
Cost basis	\$643,045	10.24%
Market value	\$938,317	14.94%
Difference	\$295,272	4.70%

**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
<b>Cost of treasury less than market value - 139 issues</b>		
Market value of companies	\$3,398,322	
Cost basis of treasury shares	\$364,818	10.74%
Market value of treasury shares	\$634,475	18.67%
Difference	\$269,657	7.94%
Cash	\$239,127	7.04%
Cash & market value of treasury	\$873,602	25.71%
<b>Cost of treasury less than market value - 35 issues</b>		
Market value of companies	\$644,703	
Cost basis of treasury shares	\$132,901	20.61%
Market value of treasury shares	\$105,548	16.37%
Difference	-\$27,353	-4.24%
Cash	\$56,411	8.75%
Cash & market value of treasury	\$161,958	25.12%
<b>Issues with full treasury data - 174 issues</b>		
Market value of companies	\$4,043,025	
Cost basis of treasury shares	\$497,719	12.31%
Market value of treasury shares	\$740,023	18.30%
Difference	\$242,304	5.99%
Cash	\$295,537	7.31%
Cash & market value of treasury	\$1,035,560	25.61%

### **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 for the first quarter of 2006 with prices and values of that time period used. 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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