

Market Overview

Regarding Federal Reserve policy, the “Mexican standoff” that we have described in previous commentary has abated. The camp expecting a sharp downturn in the economy (particularly as a result of the weakness in housing) and near-term Federal Reserve rate cuts has capitulated. The emerging consensus is for modest re-acceleration of economic growth in the second half of 2007, and for the Federal Reserve to stand firm and maintain rates at current levels until such time as the data dictates a change in course. The Federal Reserve has in fact clearly stated that it will remain open to further rate hikes if future data so warrants. A steady economy and stable policy outlook has been our view for sometime and recent economic releases validate this view. Data continues to show that the economy remains buoyant, the job market remains strong, and inflationary concerns remain in place. Labor markets remain solid, as evidenced by the employment data released at the end of June. Non-farm payrolls rose a better-than-expected 132,000 in June and were revised upward a combined 75,000 for both April and May. The jobless rate held steady at 4.5%. The latest Institute of Supply Management manufacturing survey came in at its highest levels in 12 months, and the closely watched University of Michigan survey of consumer confidence has rebounded from weakness earlier this year and now stands in line with historical averages.

Overall interest rates and mortgage rates moved higher in the second quarter, and by all appearances the Federal Reserve has no desire, nor need to loosen credit. We believe the Federal Reserve continues to focus primarily on price stability and the value of the dollar as opposed to any target rate of economic growth. Federal Reserve policy may be approaching a “neutral” bias and, assuming inflationary expectations remain intact, we expect that the Federal Reserve could officially move to a “neutral” stance at some point later this year. However, we still do not think that the Federal Reserve will initiate an easing of monetary policy near term. Pardon the cliché, but about the only thing certain now about Federal Reserve policy is uncertainty. Whether the next move in the Federal Reserve Funds rate is up OR down will be the subject of much debate, and will only be determined by the preponderance of data over the coming quarters. As the Federal Reserve ended its cycle of rate hikes last spring, we opined “...that monetary policy and the Federal Reserve Funds rate will likely remain relatively stable for many quarters.” We still hold this view, and any change in policy could now be pushed into 2008 and beyond. We also expect longer-term rates to remain range bound, albeit at higher overall levels than in recent quarters. Whereas the 10-year U.S. Treasury has held to a basic range of 4.50%–5.00% for the past 12 months, we believe a new range has been established between 4.80%–5.30%. We would also not be surprised to see the yield curve revert to a flatter form.

Regarding credit spreads, the re-pricing of risk that has taken place in the credit markets provides opportunities to now own certain credits at markedly higher yields than just six months ago. While it is impossible to pick market tops and bottoms, this re-pricing significantly changes the risk-reward equation in our view. As discussed earlier, the majority of the re-pricing has been caused by technical factors. A fair amount of the volatility we have been seeing relates to nothing more than “headline chasing” rather than fundamental changes in credit quality or concern of a systemic threat to financial liquidity. The economic conditions and outlook for credits in our core investing sectors remains mostly unchanged. Valuations in autos and auto parts have held up

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pretty well, and we expect that the negotiations now beginning with the UAW on a new labor contract will ultimately be a net positive for the sector. Homebuilders have been taking it on the chin in the credit markets throughout this downturn, exacerbated by fears relating to sub-prime mortgages and resulting tightening of home mortgage lending standards. The operating results of the sector have been predictably horrible in the first half of 2007 as most companies have faced very difficult year-over-year comps. During the second half of 2007 and first half of 2008, we expect the operating metrics of the sector to improve as comps ease and many companies use free cash flow to reduce debt. In energy, we believe the LBO/private equity party is not over, so there will continue to be winners and losers within the sector. Lastly, we expect that the underlying strength in the equity markets will likely be tested in the second half of 2007. In our view, too much of the year's performance is attributable to share buy-backs, currency translation, and commodity prices, none of which are sustainable characteristics. We would not be surprised to see additional flows out of equities and into fixed income, which would provide an additional "bid" to credit. The credit markets will continue to face uncertainty in the near term, at least until we get through the majority of second quarter 2007 earnings reports, and while first half returns have been below our target, we are confident that the second half of 2007 will provide us with ample total return opportunities.

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