



## Quarterly Commentary 4th Quarter 2005

For the most part, 2005 was another exceptional year for equity performance for our clients. We finished our seventh consecutive year of strong relative composite performance, and our third consecutive year of unexpectedly large positive gains. Industries that provided the best returns were not a lot different than the previous year. They included energy, oil and gas service companies, transportation, industrial metals, gold and forest products. Our worst performers, with the exception of **Goodyear**, were in the automotive industry. In a year when it paid to be defensive in the bond market, we had very good relative fixed income performance.

We think we should spend a moment or two explaining why we started the first paragraph with the qualifier “for the most part.” During the year, we were fortunate to add several new clients. As we would expect during a period of strong performance (and a year during which we did more selling than buying), our newest clients did not enjoy the returns of our more tenured ones. This variance in performance resulted from our hesitancy to “carbon copy” each new portfolio to look like the rest. We believe that our clients are better served in the long-term if we select the best values available at the time, rather than mindlessly replicating our existing portfolios. This variance from composite performance will be reduced over the long-term as each client’s experience with us increases in duration.

In our last two years’ final quarter commentary we began by repeating a cautionary statement about future expectations regarding our performance. We decided not to quote verbatim our introductory paragraph of the last two years in order to avoid further redundancy. But we feel it imprudent to allow our readers to escape this reading without one more reality check. The last three years’ performance, while extraordinary, will probably not be repeated in our careers (no doubt true for the last seven years of relative performance as well). That said, we are still convinced that investors are best served by using a conservative value approach. Despite the lack of abundant investment opportunities at present, we feel a long-term investor

can expect better than average returns from employing this approach. Currently, many value investors with recent good performance have closed their doors to accepting new accounts. We considered this briefly, but opted not to for two reasons. First, being in Little Rock and outside the sphere of the big money centers and big money investment consultants, the growth we have experienced has been manageable to this point. Secondly, and more importantly, closing off new accounts discounts the value we feel we can provide by helping investors avoid serious mistakes. Not that we don't make some mistakes, but the value approach has historically helped in reducing the risk of overpaying for a security. We feel that by overpaying, an investor runs the biggest probability of a permanent loss of capital, which is how we define risk.

In summary, we are very gratified by our recent performance but want to continue to caution our clients that this does not reflect our expectations for the future. We are rededicating ourselves to uncovering new opportunities that will provide the future growth in our clients' portfolios.

### **One Man's Inflation**

The spectacle in early November of the CEOs of the nation's largest oil companies being summoned to Washington to testify to Congress about the industry's recent profits got us to thinking about how people perceive inflation. The politicians saw such an opportunity to make political hay that even the governor of our home state jumped on the bandwagon. These two events took place during the time when gasoline had gone over three dollars per gallon. You will recall that this was during a time when about a dozen refineries had been taken offline due to two successive hurricanes, Katrina and Rita. The price quickly declined within weeks of the hurricanes, after most of the refineries came back into production. At that point, the politicians seemed to quiet their rhetoric and it seems to be less of an issue with the public at this point. Funny thing, but during this entire dust up we never heard even an attempt at an answer to our question "if not price, what mechanism should be used to ration a finite supply of gasoline?" We'll take our chances with free market price allocations over government directives every time.

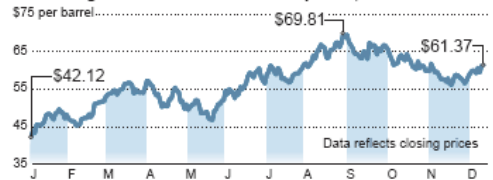
As we said, the whole event started us thinking about how people perceive inflation. We have just gone through a period in this country when house prices accelerated at a rapid rate. There didn't seem to be a lot of consternation about inflating home prices while this was happening, even though it was hurting a minority of the population, that being first-time home buyers and homeowners wanting to upgrade. We think it did not become an issue because the majority of

the public actually felt that they were benefiting from the inflation in home prices, probably not considering the eventual increase in property taxes. This is what economists refer to as the wealth effect. People feel wealthier when their assets increase in price, whether it be a real price increase or from inflation. Apparently there are more drivers of automobiles in this country than there are shareholders of oil companies, because the public seems much more sensitive to the price of gasoline than to the price of homes. If one man's inflation is another man's wealth transfer, you would think that more people would want to own shares in oil companies. This has happened to some degree, but not to the level that oil industry shares are treated as a growth industry, based on the current price of oil. Oil stocks continue to discount a much lower price of oil. We will see what the future holds, but as Matthew Simmons, an oil industry analyst/investment banker has noted, oil at \$65 per barrel is only 9.7 cents per cup (a barrel of oil being 42 gallons). Compare that with what folks seem to be willing to pay at Starbucks for a cup of their favorite morning caffeine fix, and if not enlightening, it is at least amusing. Maybe that is why Starbucks is priced like a growth stock. At any rate, we do not pretend to know where the price of oil is going, but we would definitely admit to being surprised if it goes back to \$25 a barrel (3.7 cents/cup) or below.

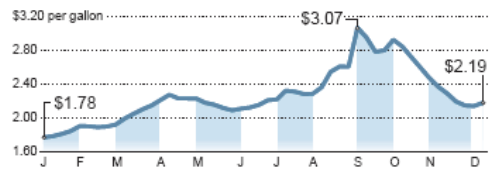
### Energy costs soar in 2005

As crude oil soared to almost \$70 a barrel in late August, consumers started taking on higher prices in gasoline and other energy.

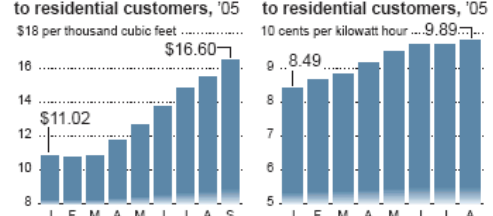
NYMEX light sweet crude oil futures prices, 2005



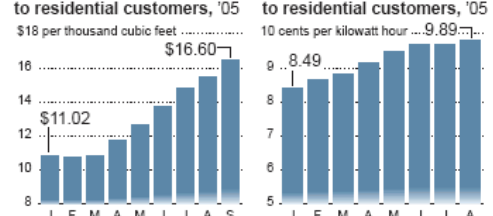
U.S. weekly average retail gasoline prices, all grades, 2005



Average price of natural gas to residential customers, '05



Average price of electricity to residential customers, '05



SOURCE: Department of Energy

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The point to this discussion (finally!) is to illustrate how public perceptions, supply and demand, and inflationary fiat money are all at work in setting asset prices in today's economy. There is a huge amount of money sloshing around out there looking for an asset to buy. This has the potential to create huge wealth transfers. Our job is to stay ahead of inflation. While we do not know for sure where and how inflation will manifest itself, it is our plan to invest your assets in a fashion that at least gives our clients a fighting chance to do so.

## **Mason Dickson**

We are very pleased to announce that Mason Dickson has joined our firm as a research analyst. Mason comes to us from Merrill Lynch, his first employer upon graduating from the University of Arkansas with a Bachelor of Science degree in Financial Management and Investments. Mason also worked in the brokerage industry during his college years and gained personal experience in investing at an early age. He attends First United Methodist Church of Maumelle and serves as Regional Ambassador Coordinator for the Arkansas Alumni Association. In addition to his research activities, Mason is learning the administrative functions of our business and preparing to sit for the Chartered Financial Analyst exam. We hired Mason with the recognition that the concept of value investing was second nature to him. It is our intention to share with him the training we have received from others, and at the same time learn from him as well.

In closing, we would like to express our gratitude to all of our clients for your continuing support of our work. 2005 was a great year for Foundation Resource Management. In addition to adding Mason and surpassing the \$1Billion mark for assets under management, we were able to achieve several process improvements on the administrative side of our business and started the year by upgrading our offices from spartan to adequately functional. Our wish for 2006 is for health, happiness and prosperity for each of you. As always, if you have a concern or questions about our actions in your portfolio, or if we can provide administrative service, do not hesitate to call on us.