Quarterly Commentary
2nd Quarter 2006

Exactly four years ago in this same space, we stated that we were optimistic that, in the wake of the Enron, World Com, Adelphia and Tyco scandals, corporate governance practices would improve. There is not much doubt that Sarbanes Oxley, passed in response to these events, has made management (and public accounting firms) much more sensitive to the reliability of the public filings of financial statements and other data. So, to that extent, there has been an improvement. Unfortunately, improvement in other areas of governance has not occurred to the extent we envisioned four years ago.

When we think of corporate governance, we are focused on **all** areas where the board and management have the opportunity to direct their decisions and actions for the benefit of the company and its shareholders. Rights plans (also referred to as poison pills), executive compensation (including stock option grants and long-term incentive plans paid in stock), stock buyback plans and dividend payout are all policies that can impact our return as shareholders. As a group, we believe these policies indicate the level of "shareholder friendliness" of management and the board of public companies. We have just finished the season when we review the proxy statements and annual reports that contain most of this information. Unfortunately, we do not get the feeling that it is the shareholders that are receiving primary consideration in the establishment of these policies. Call us old fashioned, but we believe the owners of the business should be the ones to reap the rewards of taking the risk of ownership.

By reviewing the trends in each of these practices, we think you will come to the same conclusion we have reached.

Rights plans are generally designed to ward off unsolicited takeovers by those that may not be friendly to current management. Typically, poison pills involve the issuance of rights that are triggered in the event of an unsolicited offer. These rights will result in the issuance of additional voting shares to current shareholders in the event a potential acquirer obtains a certain percentage of the stock

(usually 10%-20%). All shareholders receive the new votes except for the potential acquirer, thus diluting the ownership of the intending acquirer and making eventual control of the board much more expensive. It is natural that non-management shareholders would oppose such takeover defenses, as these types of offers are one way that the full value of their holding can be realized. However, according to CFO.com, it is arguable that this defense has been employed through the eighties and nineties primarily as a mechanism to buy time and get the best possible deal for the management of the targeted company. CFO.com states that for the four years from 1997-2000, "for every company with a poison pill that successfully rebuffed an unwanted advance and remained independent, 20 pill-protected companies accepted takeover offers." So it seems that rights plans are now primarily used as leverage for managements to work the deal that is best for them. The trend in poison pills is a mixed bag, according to SharkRepellant.net. While larger companies are beginning to drop these plans in response to shareholder initiatives, smaller companies continue to employ this defense. We tend to favor shareholder initiatives to remove poison pill defenses.

Before we get into a discussion of executive compensation and stock option grants, let us first state our broad position on executive pay. In general, we believe that managements of large public companies should be very well paid. The running of these companies is a huge responsibility that usually consumes almost all of the executive's waking hours. We recognize that talented individuals making such a commitment must be very well compensated.

Today, salaries and bonuses of top execs, while very generous, generally fit the above criteria as acceptable. Some of the perks we read about do seem a little ridiculous to us to the extent that we wonder if some CEOs pay any personal expenses whatsoever. However, it is not executive salaries, bonuses and perks that have made total compensation skyrocket. That is the result of stock option programs and long-term incentive plans.

There are many complexities involved valuing stock option grants, so we must be careful about throwing around numbers on total compensation. A recent *Fortune* article (June 26, 2006) stated that median total compensation for CEOs of the S&P 500 companies was $8.4 million in 2005. That same article cited a study which showed that the median total compensation for the top three executives of the largest companies has gone from 33 times the average worker's pay in 1980, to 55 times in 1990, ratcheting up to 119 times in 2000. The figure for the most recent year available, 2004, was 104 times.

So there has been a sharp increase in the level of total compensation relative to that of the average worker.

The reason we take issue with current option grant programs and long-term incentive plans (LTIPs) is that a manager gets the economic reward of risk taking, without taking any risk. We could spend the rest of our allotted space (that maximum amount which you might be willing to read) on this discussion, but we will try to resist the temptation.

Stock option plans gained great favor in the eighties as a non-cash way of compensating management and at the same time attempting to align management and shareholder interests. With stock option plans, management captures the appreciation in the stock price from the date of the grant, risk free. Prior to the expiration date, if the option is “in the money,” the grantee gets to buy the stock at the price that existed at the time of the grant, thus getting a risk-free gain. If the stock has not appreciated or has declined, for whatever reason, the option simply expires worthless. The employee has not gained anything, but he has not lost or risked anything either. These plans have the potential to dilute our ownership position, depending on whether management, under a plan approved by the board, goes into the market to buy stock in order to cover the issuance for those shares exercised. Some feel that these plans have served to make managements too sensitive to the stock price, and have thus, in some instances, contributed to short-term management focus and probably some accounting manipulation as well.

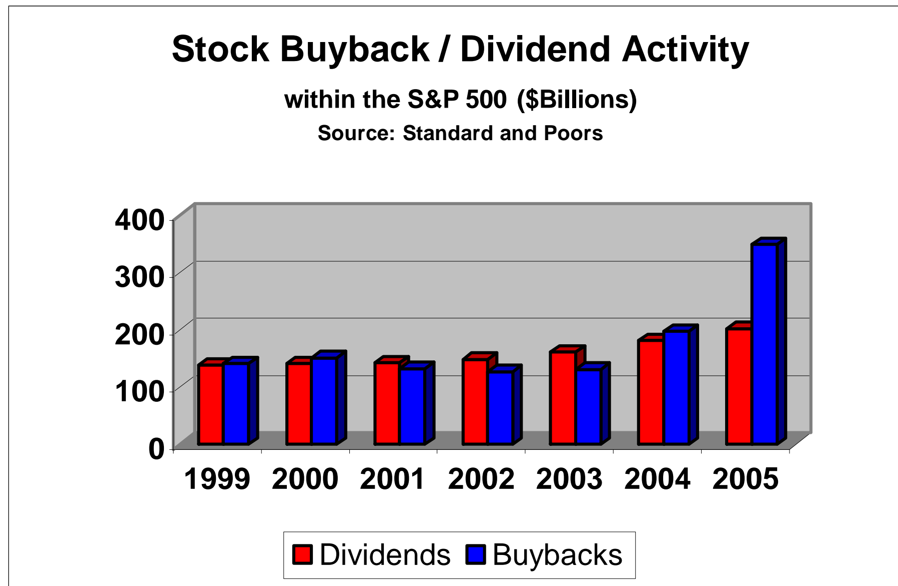
Very recently, under scrutiny first by the *Wall Street Journal* and now by the SEC, evidence of manipulation of these plans to greatly increase the probability of appreciation in the value of the option has been uncovered. More than fifty companies have come under SEC investigation for the practice of backdating of the option grants to a date just prior to a significant increase in the price of the stock. This practice has been likened to being able to bet on a winning horse after it has crossed the finish line. Strangely, this practice may not be considered fraudulent in all cases, but it has wreaked havoc for the companies involved because they understated the expense of issuing a grant that so obviously had economic value when issued. Several restatements of financials have already been announced, and we would not be surprised if many more instances of backdating are uncovered.

A similar practice, known as “spring-loading” involves the granting and dating of an option just prior to favorable news being made public by the company. The SEC is investigating this practice as well, but it is not clear to what degree they

will pursue it. One SEC commissioner noted that this practice is much more difficult to assess, since it is not always certain what impact an announcement will have on the price of a stock. This same commissioner argued that spring-loading allows the company to issue smaller option grants than would otherwise be required, thus benefiting stockholders. We don't buy that argument, since it is obviously an attempt to give the manager a high probability of getting a head start over the life of the option.

Recently, LTIP awards of stock have increased in response to shareholder dissatisfaction with stock option plans. LTIPs can take many forms, varying with regard to vesting requirements, performance requirements, restrictions on sale, the use of phantom stock units and the payment of dividends on the stock. These plans do address the problem of managements immediately selling stock upon the exercise of options, assuming that hedging is prohibited. In our view, they are only slightly better than stock option plans from the standpoint of management's risk position in the stock. True, LTIPs give management an immediate sense of ownership, but compare this with the statement very few managers make when they are willing to actually buy stock with their own funds. Given the size of some of the LTIP awards of stock we have seen, it seems that total executive compensation is continuing to rise rapidly.

Now that stock ownership plans have been extended to board members as well, we believe they are beginning to cause directors to favor share buybacks over dividend payouts. Absolutely nobody seems to be talking about this issue, but the facts are that even though stocks in general are very richly priced, managements continue to pour money into their own stock. This occurs during a time when dividends are being taxed very favorably. True, the same can be said for capital gains, but we tend to favor dividends over stock buybacks for two reasons. First, as touched on above, most managements have not shown a great price discipline when acquiring their stock. In our view, overpaying for one's stock is not much different than overpaying for an acquisition. Secondly, the benefit of a dividend payment is immediate, direct and easily quantifiable as opposed to the potential benefit measured over time of having increased earnings per share (all other things being equal). This increase in earnings per share will occur during good and bad stock markets, so the value of the benefit of fewer shares outstanding is unknowable over time.



The above chart reflects the high growth rate of stock buybacks. In the last three years, a very good period for the stock market as well as corporate profits, it is easy to see where the money is flowing. We do not believe that this trend is in the best interests of shareholders.

To summarize, the anticipated move toward governance and management policies more attuned to shareholders that we had hoped for four years ago has not occurred. While some progress has been made regarding management accountability for accounting and reporting, we have been disappointed that most boards of directors have not done more to act in the best interests of shareholders.

Relative Value vs. Absolute Value

It seems that everywhere we turn in the financial press these days, there is a value manager talking about having recently bought some of the largest blue chip stocks. Typically, he or she states that these stocks are cheaper relative to the rest of the market than they have been in many years. Thus, the argument follows…quality is "cheap on a relative basis."

We agree that these stocks are currently cheaper relative to the rest of the market than they have been in a long time. We would even agree that they are cheaper relative to their fundamentals than they have been in many years. But we **would not** say that these stocks now offer our clients the opportunity for a high return on **their** equity.

	P/E	P/CF	P/B	Avg. ROE for 5 yrs. (%)	Avg. ROE/(P/B) (%)
General Electric	19.2	12.9	3.2	20.20%	6.39%
Pfizer	11.6	8.4	2.6	31.90%	12.07%
Anheuser- Busch	18.8	12.3	10.6	64.56%	6.10%
Wal-Mart	18.3	12.7	3.8	20.26%	5.37%
Microsoft	20.1	18.3	5.2	19.98%	3.85%

P/E-Price-to-earnings ratio
P/CF-Price-to-cash flow ratio
P/B-Price-to-book value ratio
Average Roe for 5 yrs. (%)-Average return on equity for the last five years

Source: Value Line using closing prices at 6/30/06 and 2005 earnings per share, cash flow per share and book value per share.

The above table represents five great companies with their associated measures of the fundamentals in which we are most interested. At a glance, the numbers may not mean a whole lot to you, but we would turn your attention to the average ROE for the last five years. These are obviously very attractive rates of return that any rational investor would be pleased with. A different story is told, though, when you adjust these numbers for the ratio of price to book value in the third column from the left (divide the average ROE by the price to book value). In essence, this calculation adjusts a company's ROE for the price an investor must currently pay for their stock. This adjustment is reflected in the far right column. With the exception of Pfizer, these figures do not reflect the kind of returns we seek when investing in common stocks. It is no coincidence that of the five companies listed, Pfizer is closest to our target price for purchasing the stock.

One other note of interest before we depart this discussion. You might look at Anheuser Busch and ask how a company generates a ROE of 64.56%. Remember our discussion of stock buybacks above? By purchasing more than 353 million shares of stock over the last fifteen years at prices we would consider expensive, the management has reduced stockholder's equity (the denominator in ROE) significantly. Because of the resultant increase in earnings per share, and to some degree increased total profits, a very high ROE is attained. However, the adjusted ROE gives you an idea of the kind of returns that management has been achieving when placing this stock in the treasury. We would judge that this has not been a beneficial endeavor for shareholders and that they would have been better served with increased dividends.