Quarterly Commentary
3rd Quarter 2006

"He who sells what isn't his'n must buy it back or go to pris'n." attributed to Daniel Drew, famous American short seller 1797-1879.

Picture this scenario. **We** decide that **your** house is overvalued. You are not remotely desirous of selling your house, which your family has lived in comfortably for many years. You love your neighborhood, which has only improved, in your mind, since you moved in. You love your house. Nevertheless, you wake up one day and discover that we have sold your house because we believe we could sell your house for more than it is worth. We believe that we can eventually buy your house back in the future at a substantially lower price and profit from the difference. Now to improve our odds of success, we decide after selling your house that we will use our financial influence by "encouraging" our business contacts to write very negative articles about your neighborhood being considered as a future nuclear power plant sight. The prices of houses in your neighborhood plummet wherein we swoop in and buy your house back at a depressed price, pocketing a cool profit.

What we have just described is an increasingly popular phenomenon in the securities markets called "**naked short selling**." In naked short selling, an investor shorts (sells) a stock without first making necessary arrangements to borrow shares. That often means the short seller fails to deliver the stock to the buyer and the trade fails to settle, running afoul of securities laws. Naked short selling is not the only cause of failures to deliver shares, but it is likely the major one for heavily shorted stocks. This practice of naked short selling has become more widespread, partially because those who borrow shares must sometimes pay hefty fees or loan rates if many other investors want to borrow the same stock.

Done right, short selling is both legal and appropriate. The problem with naked short selling occurs when investors not only do not borrow the stock, but also have no intention of borrowing the stock. Their sole purpose in selling is to try to drive the stock price down. There is a clear distinction between legal short selling and illegal manipulation. Naked short selling has been described as shorting on steroids and has been deemed an illegal act.

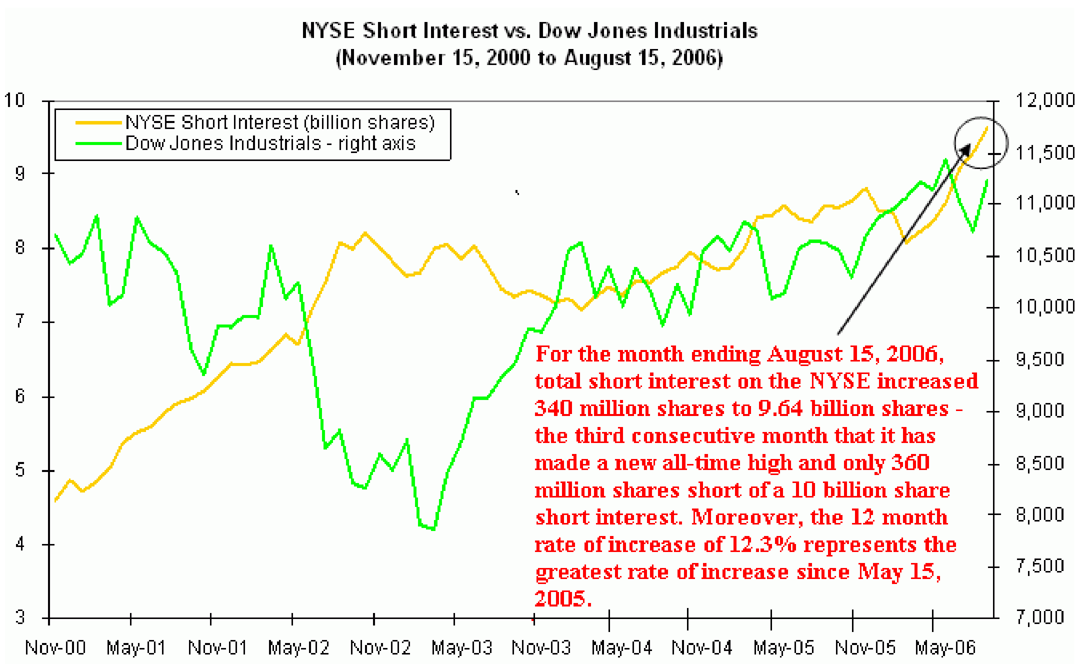
In order to control the abuse of naked short selling, the SEC implemented Regulation SHO in January of 2005, which required broker/dealers to identify a borrowable stock before executing a short sale. Regulation SHO also requires the stock exchanges to provide a daily report of all stocks that had failures to deliver of 10,000 shares or more and at least 0.5% of the issuer's outstanding shares for five consecutive settlement days. For failed settlements that persist for thirteen consecutive settlement days, Regulation SHO requires the broker/dealer to take immediate action to close out the transaction with an offsetting purchase. According to Robert Shapiro, a former Commerce Department undersecretary who is researching this subject as a consultant, roughly 12% of NYSE and NASDAQ stocks have fails-to-deliver that are at least two months old. Shapiro has also determined that there are approximately half a billion shares in the U.S. that have been sold in the past but not delivered for settlement in the required three days.

During this past quarter, five banks/brokerage firms were censured and fined by the NYSE's regulatory division for violations of trading rules meant to curb abusive naked short selling. The fines, which totaled $1.7 million, are unfortunately nothing more than a slap on the wrist for these huge financial institutions that are making tremendous profits serving as the prime brokers for the world's largest hedge funds. These hedge funds have become the tail wagging the dog in the securities' markets. Hedge funds are far more likely to dabble on the short side of the market than the traditional investment management firms and are also more active traders. It is estimated that on most days, over half of the daily trading volume on the NYSE is attributable to hedge funds, which manage well less than 10% of assets under management of the traditional investment management industry. Accordingly, the brokerage industry has become beholden to the hedge fund industry, even though it is far smaller than the traditional investment management industry.

Short selling activity became much more familiar to us during the third quarter when we received a call from a major international brokerage firm wanting to borrow our clients' shares of **Fairfax Financial Holdings Ltd. (FFH)** at the temptingly attractive annual loan rate of 30%. Last year, we were offered a 12% rate. FFH is a rather thinly traded holding with a small amount of float. In other words, a low percentage of shares outstanding are available for sale. The most recent filing reports reflect that approximately 4.5 million shares of FFH are sold short out of a total of 17.74 million shares outstanding and probably less than 7 million shares (our estimate) of available float. We determined that lending your shares would only be shooting ourselves in the foot by putting unnecessary downward pressure on the stock. We opted against the idea. What that phone call did tell us, however, was how desperate short sellers were to borrow FFH stock and how much they were willing to pay to get it.

Also in July, FFH filed a lawsuit seeking $5 billion in damages from a number of hedge funds, their owners, and brokerage firms who they allege participated in a stock market manipulation scheme likely involving naked short selling of FFH shares. Similar suits have been filed by other companies, including Biovail and Overstock.com. In a conference call with FFH management, it was stated that this was only the second lawsuit filed in the company's entire history (FFH won their only other lawsuit). They stated that they believed wholeheartedly in the ethical practice of short selling, which they have regularly utilized in the management of their insurance assets. However, FFH's management believes they have clear evidence of market manipulation of their stock by these hedge funds and their owners and that there existed a quid pro quo arrangement with brokerage firms that were routinely writing negative research reports about FFH. We are sure that it will come into question how much commission business these hedge funds were placing with these brokerage firms.

We are closely watching the short interest and its effects on our various stock holdings. In the long run, prices will adapt to reality. As long as a company is well-financed and has no immediate needs to issue equity capital, the fundamentals will always win out. If a stock is unreasonably cheap, because of excessive shorting or for any other reason, someone will eventually recognize this fact and buy stock. Better yet, they may bid for the entire company, creating a big problem for the shorts. If shares are far too expensive, as Internet stocks were in early 2000, prices will eventually drop no matter how optimistic a company's fans. Additional investment opportunities could present themselves if naked short selling continues to proliferate (see chart below).



Source: MarketThoughts.com

<u>Natural Resources</u>

You are probably aware that we have favored many stocks in the natural resource sector as we find that they continue to provide the attractive valuations that we seek. Some investors have questioned this logic since the prices of the commodities that these companies produce have risen strongly over the last several years. These investors were concerned that a bubble was building in commodities. It recently has become easier to question our line of thinking, since the prices of many commodities declined sharply in the third quarter, negatively affecting our quarterly returns. Natural gas prices dropped almost 40%, and oil prices dropped approximately 15% in the third quarter alone. Many pundits took the correction of natural resource prices in the third quarter as a sign that another "bubble" had popped. We believe that what has happened with declining natural resource prices in the third quarter is actually beneficial to the long run prospects for this sector.

Ninety days ago, there was broad-based outrage from consumers, the press, and politicians about the price of gasoline which exceeded $3 per gallon and the price of oil, which reached a peak price of $78 per barrel in mid-July. Additionally, there was a similar effect on other natural resource prices, which are not quite as obvious to consumers but just as important to worldwide economic health. There were calls for windfall profit taxes, and the CEOs of the largest U.S. energy companies were paraded before Congress as "Public Enemy Number One." Concerns about a slowdown in worldwide economic growth were justified. It may sound strange, but we believe $60 per barrel oil is actually more beneficial to the oil producers in the long-term than $80 per barrel oil. Most oil producers can make tremendous profits at $60 per barrel and stay below the radar of the press and politicians. Likewise, the economic threat of alternative fuel supplies is reduced at lower prices. Interestingly, consumers are now practically cheering $2.30 per gallon gasoline.

While every bull market has its periodic corrections, particularly after a strong run-up, the current boom in natural resources is well-supported by growing worldwide demand that will likely send long-term prices higher. We have determined that the primary reason for this bull market in resources is a fundamental mismatch between supply and demand. In the area of oil, the increasing worldwide demand is being challenged by the industry's recent inability to increase supply. Conditions are tight, with spare production capacity at only one million barrels per day versus the world's consumption of approximately 84 million barrels per day. That is not much leeway. Thank goodness for a calm hurricane season this year.

The same can be said for base metals where warehouse inventories are probably the best indicator of supply/demand pressure. For most base metals (copper, aluminum, nickel, zinc, lead), inventories reached a peak between 2002 and 2004. As demand began to outpace supply, inventories generally have been in decline since then. We believe it will be challenging for worldwide production in these commodities to keep pace with demand.

The International Monetary Fund (IMF) forecasted recently that worldwide economic growth would reach 4.9% this year, reflecting improvements in the economies of the U.S., Europe, and Japan. The largest positive influence continues to be China and India, whose economies are expected to expand by 9% and 7%, respectively. It is these two economies where the majority of growth in demand for natural resources resides. In 2006, China's industrial production has grown at an annual rate of 16.6%. Likewise, India's prime minister has recently doubled his estimates of that country's capital spending for the next five years. Increasing industrial production naturally requires larger amounts of raw materials. That activity requires more energy. In 2005, emerging markets collectively accounted for 90% of incremental demand growth for oil worldwide.

The other factor to consider is that bull markets in natural resources typically last a long time, eighteen years on average. The reason is that it takes many years to identify and develop new mineral deposits. An example is the announcement in September of a large discovery by three oil companies in the deepwater of the Gulf of Mexico. It will be many years before peak production will be reached on this find. The same can be said for base metal mines that tend to be located in challenging geographic and political areas.

Moderate Future Returns Expected

In the April 2000 Berkshire Hathaway shareholders' meeting, Warren Buffett was quoted as saying, "We don't think the general ownership of equities is going to be very exciting over the next 10 to 15 years." After 6½ years, he could not have been more right. As the 2006 third quarter came to an end, newspaper headlines were boasting that the Dow Jones Industrial Index was hitting new highs. Said a more logical way, which factors time into the equation, the Dow has produced zero appreciation for the last 6½ years. The S&P 500 Index is still well below its all-time high and the NASDAQ still would have to appreciate by over 100% to reach its all-time high. Although the last seven years have generally been good ones for our clients, the broad stock market returns have been less than exciting. Even though stock market valuations are more attractive today than 6½ years ago, projected broad market returns remain rather subdued compared to long term rates of return. Thankfully, our investment focus remains on individual securities rather than attempting to predict how the stock market will generally behave.

A Word About the Bond Market

We wish we had more enthusiasm to share with you about today's bond market. While interest rates have risen over the last three years (mostly on the short end), so has the overall inflation rate. Real yields are rather unexciting as a result. Credit spreads remain quite narrow relative to historical norms due primarily to a strong economic environment. U.S. corporate profits have grown at a double-digit pace for a record thirteen consecutive quarters, so we believe many bond investors have let their guard down about credit risk. We do not believe the economic cycle has been repealed, so credit risk will undoubtedly come back into play. At that point, our enthusiasm for taking credit risk will rise. We just do not know when that will be. We do not believe that now is a good time to take high levels of interest rate or credit risk.