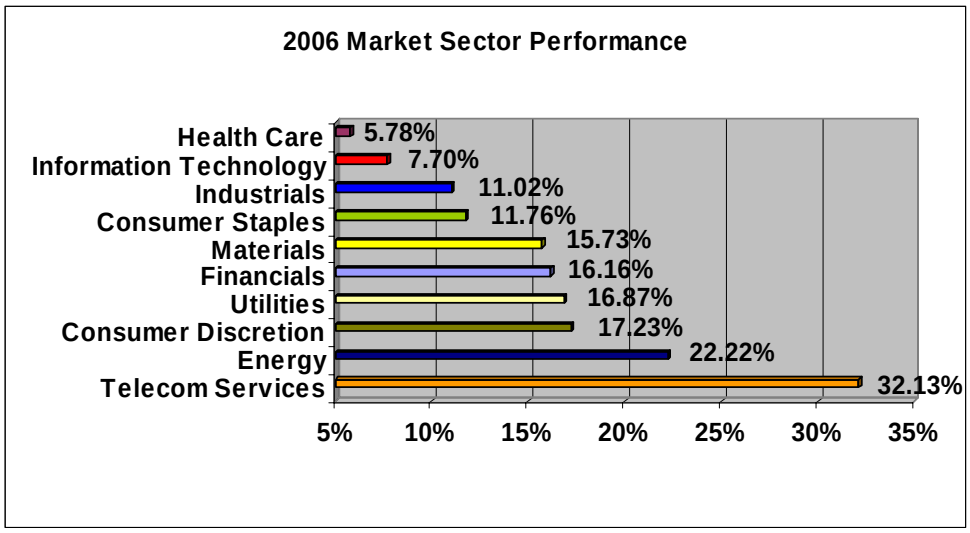
Quarterly Commentary
4th Quarter 2006

Looking back on 2006, it was a good year.

A strong fourth quarter provided good annual results for our equity portfolios. Our positions in energy and materials were again some of our best performers. The fundamentals of our energy stocks remain very strong, despite a sharp decline in natural gas prices for the year. We end the year with a much reduced position in the materials sector, due to acquisition activity by foreign buyers using cash. Our chances for re-entering this area of the market soon do not appear good due to the reduced number of public companies in this area and the valuations on the names that remain. Financial stocks also provided very good returns during the year, particularly property and casualty stocks, as they rebounded from the devastating impact of hurricanes Katrina and Rita in 2005.

Our results in fixed income were also very good for 2006. In a year where low quality outperformed high quality, we used a low duration, high quality approach to provide superior performance. Our large position in GMAC was our best performer overall. Also, our position in New Zealand bonds (in those portfolios where we could have such a position) was highly additive thanks to a second half rally in the New Zealand dollar versus the U.S. dollar.

Our main frustration during the year stemmed from the lack of new opportunities. According to *Barron's*, we are now in the longest period on record without a 10% correction in the broad market. That was not a surprise to us because the new low list, the source of many of our research endeavors, was practically unpopulated for most of the year. Additional evidence of the lack of bargains comes from the returns for the ten major sectors of the S&P 500, (see below), none of which was negative.



Source: Wall Street Journal

We remain hopeful, particularly for our newer clients, that 2007 will bring opportunities for attractive valuation levels that will warrant the addition of new positions.

The Investment Environment circa 2007

As we close out another year and look to the unknown future, we think it important that we consider the current investment landscape. We understand that most people spend little or no time weighing the issues we will discuss, as they are involved in the industry of providing a living and/or raising a family.

Our work of security analysis and portfolio management is carried out in at least two realms: the world economy and its subset, the world of finance and investments.

As we all know, the world economy is more connected and inter-dependant than ever before. Money flows between nations rapidly, but the fiat money that flows is paper money, or electronic bookkeeping notations, that only have real value because people are willing to accept such as settlement for business transactions. This type of money is referred to as fiat money because it is issued by a nation's government and is the "coin of the realm" by virtue of government fiat (in contrast to money that is tied to something of value).

In today's world, all money is fiat money. The various currencies of the world fluctuate in value relative to one another, but all have a history of depreciating (inflating) over time. Today, no government seems to want a strong currency. With cheap money policies, governments today focus on protecting their domestic industries and enhancing their international competitiveness. This causes a wealth transfer from creditors to debtors and discourages saving. In our own country, we have gone from the world's largest creditor nation to its largest debtor during the lifetimes of what has been referred to as "our greatest generation." Not unlike the years immediately following WWII in our country when people of modest incomes were the savers and the affluent were the borrowers, today our nation borrows from nations with much lower income and wealth.

The way that credit can be expanded in the economy has evolved over the years. Today, low interest, easy money policies are mostly carried out through the use of what the famed Austrian economist Ludwig von Mises referred to as "circulation credit." He noted that there were two pools of credit available. The first he referred to as "commodity credit," which is derived from savings from delayed consumption as discussed above. The second type is circulation credit. In Mises' day, circulation credit was generated through the loan process of banks. This is the typical money creation process that you business majors learned in undergraduate business school. Remember Money and Banking 301? Fast forward to today and circulation credit dwarfs credit available from savings. Credit creation is no longer only in the strict realm of the banking sector. Our government has seen to that in the form of issuance of its guaranteed bills, notes and bonds that are used to create credit out of thin air in order to purchase goods and services that it otherwise would be unable to obtain. Additionally, various agents of the federal government have been directed to issue debt to assist different sectors of the economy such as housing and agriculture. Today those agents' issues are perceived in the market place to be as creditworthy as those of the government. Last but not least, other sectors of the bond market (e.g. corporate and municipal bonds) have evolved into a highly efficient method of borrowing for these entities. In today's world of finance, the ease of obtaining credit is enhanced by the development of these bond markets.

Because of these highly developed credit markets, it is primarily the price of credit that determines whether conditions are "easy" or "tight." Coupled with the structural changes in credit markets over the years, low interest

rates have led to a period when credit appears to be more easily obtained than at any other time in our country's history.

By now you might be wondering how all of this impacts the investment landscape. In April 1946, Professor Ludwig von Mises prepared a memorandum for a group of businessmen for whom he served as a consultant. In the memorandum titled, "The Trade Cycle and Credit Expansion: The Economic Consequences of Cheap Money," Mises describes a period of "malinvestment" fostered by expansion during periods of easy credit. During this period of boom, "many projects which were previously deemed unprofitable get the appearance of profitability. The entrepreneur who embarks upon their execution must, however, very soon discover that his calculation was based on erroneous assumptions. He has reckoned with those prices of the factors of production which corresponded to market conditions as they were on the eve of the credit expansion. But now, as a result of credit expansion, these prices have risen. The project no longer appears so promising as before."[1] Eventually, the boom and resulting malinvestment (e.g. house building in 2005) gives way to a period of tighter credit and a sobering realization that investment profits are not as easily accomplished as was assumed during the initial up phase. It is our job to protect your capital at all times, and it is especially important that we do so during the credit expansion. We believe that easy credit has been with us most of the last twenty years. We also believe that this has inflated the prices of most assets. When the cycle does change, many bad investments will be exposed. It is our goal that your capital will be protected better than most. We also expect that opportunities will arise on the day of reckoning.

For fixed income clients/investors, it is easy to see that with a system biased toward inflation, a security that promises to pay a fixed return and principal upon maturity in fiat money puts one at an immediate disadvantage. We particularly view investment in long maturity fixed income assets as interest rate speculation in such an environment. It is for this reason that we have recently begun to entertain the concept of and have made a small entry into the world of foreign bonds denominated in foreign currencies. While still possessing the weaknesses of other fixed income instruments described above, such investments do hold the potential for a hedge against a decline in the U.S. dollar relative to other currencies. Even though equity

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[1] *Mises, Ludwig von. "The Trade Cycle and Credit Expansion: The Economic Consequences of Cheap Money." Memorandum presented to a community of businessmen for whom he served as a consultant, April 24, 1946.*

investments (common stocks, real estate, collectibles, etc.) promise price volatility and unknown returns, at least they give the owner a fighting chance of holding an asset that might sustain or even gain in purchasing power. For an individual, this could mean the difference between erosion and maintenance of their standard of living.

Assuming we haven't lost you at this point, let's move on to the world of finance and investment as promised. Our friend, Harold Dulan, used to say that the world of finance and investments was like a jungle. Imagine a jungle with extremely thick vegetation that has been booby-trapped and land-mined. That is the picture we think he was trying to portray and it is that landscape that we are trying to navigate with your capital. There is an ever increasing proliferation of "booby traps" and "land mines" being foisted on the investing public by the sell side (the sell side being Wall Street and all other peddlers of securities generally compensated on a transaction basis). While you may not see this happening, a good portion of what we do for you and the value we provide comes from avoiding these pitfalls through independent, unbiased analysis.

In this jungle, one of the areas of caution we see that we have discussed many times is the rush to private equity and hedge fund investing. These strategies actually started out as buy side approaches but are now marketed vigorously in sell side fashion by the buy side and sell side alike. Thus is the demand for the promise of investment performance that both sides are engaged in feeding this monster. (Other areas of the investment jungle discussed in the past: the long-term trend to short termism, benchmarking as the holy grail of measuring investment performance and potential conflicts of interest in the world of finance too numerous to mention.)

We summarize this synopsis of the current investment environment by concluding that it is more complex and fraught with potential peril than ever before. The way we have successfully navigated this landscape thus far is by sticking to the discipline that we have been taught and that has proved so valuable in the past. Our plan is to continue to do so in the future.

We close the year 2006 with the recognition that over the years, it is our clients that have provided us with the opportunity for FRM **and** its clients to be successful. Not only have you provided capital to invest, but you have also added confidence and patience, key ingredients to the successful formation of an investment team. We sincerely thank you for that. We wish

each one of you continued prosperity, good health, and happiness in the new year.