



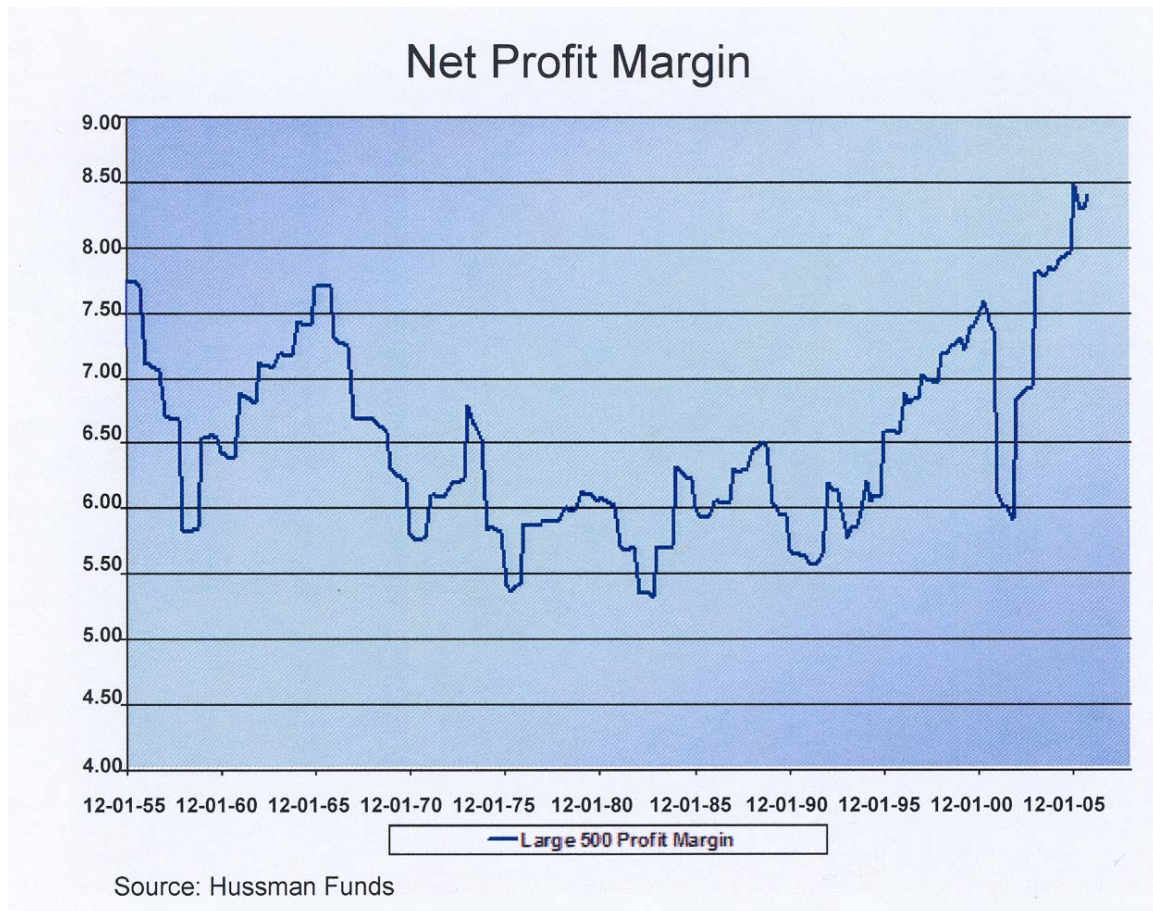
Quarterly Commentary **1st Quarter 2007**

In almost every recent client meeting, a thorough discussion has taken place regarding the challenges we face in identifying undervalued bargains in the securities markets. We have never had greater difficulty in our careers finding them. Usually a bull market in one asset class or industry coincides with a bear market in another important asset class or industry. Reviewing the five most important asset classes – equities (both domestic and foreign), bonds, commodities, real estate, and collectibles – all have produced solid returns for the last five years. With the slight exception of domestic residential real estate, which has only recently begun to correct from an over-heated situation, all asset classes appear in the rich category as we search for high future returns on our clients' capital. A few years ago, we identified bargain stocks in the energy industry, shipping, manufacturing, industrial metals, property casualty insurance, and timberland. Corporate bonds were also priced to handsomely reward investors several years ago.

Let us take this time to remind our clients that our over-riding day-to-day focus is on individual security analysis rather than market analysis. We have never made our clients money "predicting" the stock market. We do, however, believe the market's overall measurements can say something about the availability of attractive individual investment options. We believe, for the purposes of this commentary, it is more efficient to discuss broader measurements rather than each individual security that we have determined to be currently over-priced.

On the surface, one might think that valuations in the stock market are not all that rich, particularly when measuring the cost for a dollar's worth of earnings. Selling at approximately 18 times the past four quarters' earnings, the overall market does not appear excessively over-priced as compared to an average of approximately 15 times over the last 80 years. Nevertheless, we must place those earnings in historical context. We never attempt to predict company earnings in the future throughout our research process. Wall Street has created an entire industry for just such an approach, and we believe it has failed miserably in the forecasting business. Frankly, we do not have confidence that we would be any better at it than Wall Street. We do, on the other hand, attempt to analyze a company's past earnings history over long periods of time (five to ten years or longer) so that we can smooth out (normalize) the big swings in earnings that can make stocks appear artificially undervalued or overvalued. Cliff Asness of AQR Capital Management recently noted that the market's normalized Price/Earnings ratio currently stands at a very high 25 times (67% higher than the long-term average).

Historically, net profit margins tend to be economically cyclical (see chart below).



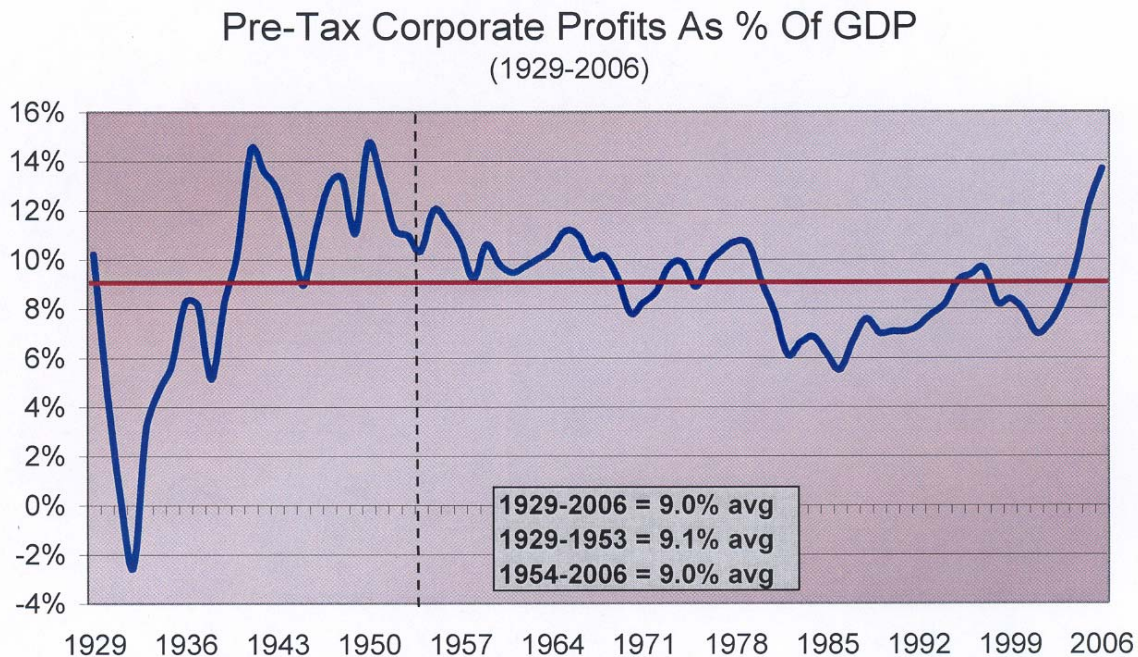
The 50-year profit margin (after-tax net income divided by sales) range for the S&P 500 Index has generally been 5.5% to 7.5% of sales. Only four times in the last 50 years have profit margins climbed above 7.5%, and the first three times, they quickly fell below the mean. Now the fourth time, profit margins have ascended to a 50 year record of 8.5%. To what factors do we attribute this current record profitability? First, interest expense has been in a distinct decline resulting from both lower interest rates and the de-leveraging of corporate balance sheets. Corporate interest payments, according to the 12/18/06 issue of Fortune, have fallen from an all-time high of 8.2% of GDP in 1984 to 3.9% in 2006. Second, reduced rates of corporate investment have influenced rising profit margins. Even though capital investment is not subtracted from earnings as a lump-sum expense, the plunge in capital investment since 2000 is part of a broad cost-cutting that may not be sustainable. Investment spending as a percentage of corporate profits is at a 40 year low¹ and probably sows the seeds for weaker future profitability.

On this subject of profit margins, Jeremy Grantham of Boston's Grantham, Mayo, Van Otterloo likes to say that profit margins are "one of the most dependable mean-reverting

¹ Hussman Funds

series in finance.”² When certain companies are producing fat profits, other companies enter the marketplace to compete with them, and the new competition dilutes the profits. Conversely, when profit margins are too thin, businesses tend to fail, thus opening the way for the survivors to charge more. This ebb and flow is part of the business cycle that has been around for thousands of years. “To believe that profit margins will not revert to the mean,” Grantham says, “you have to believe that capitalism is broken.”³

This same concept of reversion to the mean holds true when comparing pre-tax corporate profits to GDP from 1929-2006 (see chart below). The average for the entire period of almost eighty years is 9%. We find it interesting that the average for the first twenty-five years (1929-1953), with all its extremes, averages roughly 9%. Following 1953, the average has also been 9%, yet with less acute cycles. You can see that this measurement is now approaching 14%, which is close to an 80 year high.



Source: Crestmont Research

What do these relationships have to do with future investment returns? Possibly it matters greatly. The following table places net profit margins since 1975 into quintiles. The first row of the table contains the 20% of the periods with the lowest profit margins. The bottom row contains the 20% of periods with the highest profit margins. For each level of profit margins, the table shows the median P/E of the 500 largest stocks, their median annual return over the subsequent three year period, and their median return over the subsequent five year period.

² Lean, Mean Reversion Machine by John Mauldin 8/7/04

³Ibid

	Median P/E	Subsequent 3-Yr Annualized Return	Subsequent 5-Yr Annualized Return
Lowest 20% of Margins	12.96	15.04	15.69
2	11.34	13.45	13.79
3	16.27	13.52	13.83
4	21.00	10.44	7.49
Highest 20% of Margins	25.00	-1.02	3.45

Source: Hussman Funds

The median P/E column is worth noting. Investors consistently overpay for stocks during periods of high margins. Likewise, when earnings are weak, investors become frustrated and are reluctant to pay much even for a dollar of depressed earnings. This type of behavior has much to do with the reason value investing has outperformed both the market and growth stock investing over the long haul. It is not difficult to predict what happens when investors buy richly priced stocks with inflated profit margins.

Bargains were in abundance seven years ago when the market's average current P/E ratio reached its long-term high of over 30 times immediately before the bursting of the high tech bubble. The market was unusually polarized with high tech and telecommunications stocks trading at perilously high valuations and many mundane and old economy stocks attractively priced for high future returns. Since then, many overvalued stocks have gotten modestly cheaper and many undervalued stocks have appreciated markedly (benefiting our clients' returns) with minimal differentiation between the two.

We continue to scour the investment landscape for attractively priced stocks. Our "buy list" is as short as any we have had, so our pipeline of prospective investments is relatively dry. There is a temptation to invest in individual securities that look **relatively** cheap versus an expensive market but do not offer the kinds of **absolute** returns that we require when accepting the risk of investing in equities. Violating our value discipline is non-negotiable. Value investing has served us well, and we are confident of its long term success in the future. We are beginning to see cracks in certain stocks of a few industries like homebuilding, pharmaceuticals, mortgage financing, and newspapers, but the stock prices are not down to the levels that can provide investors downside protection from a permanent loss of capital (risk) and satisfactory absolute return potential. Likewise, the fundamental values of many of the 1990's popular growth stocks are beginning to catch up to their respective stock prices. Future investment opportunities could exist if this trend continues. Meanwhile, we are thankful that the market continues to favor the current stocks in our clients' portfolios.

You call that a correction?

On February 27th, the Chinese stock market, which had been on a tear (up approximately 130% in 2006 and up more than 30% year-to-date in 2007), dropped 9%, and the rest of the world's stock markets declined in sympathy. We have been highlighting to our clients that the U. S. stock market has not had at least a 10% correction in over four years, a record period, and was overdue. As we write this commentary, we can still say this is true. We are now over 1,000 trading days without a 10% correction in the S&P 500 Index. At its worst, the S&P 500 was down around 6% from its peak, but ended the quarter with a fractionally positive return. The consensus response to this brief downdraft appears to be that the stock market is too big to fail and that the Fed will, once again, flood the market with liquidity as it has done in the recent past. Meanwhile, the Chinese market is now at record highs with over a 40% return year-to-date. That puts the Chinese market up over 200% in the last fifteen months. Now that is what we call explosive returns! We suspect the Chinese market is in danger of over-heating.

As this first quarter downturn unfolded, we began to be asked if this was the buying opportunity that we had been looking for. Our response was that a 6% stock market correction historically was quite common and was relatively insignificant. Frankly, we were only getting back to stock levels that we had seen at the beginning of the year, and we were having difficulty finding bargains then. The new low list for the various stock exchanges continues to provide very slim pickings. However, the hunt continues.