

# Quarterly Commentary

## 3<sup>rd</sup> Quarter 2007

Around the middle of September, some of our clients wanted to know our opinion on the prospects of an interest rate cut by the Federal Reserve. We usually followed their question with one of our own, “Do you want to know what we think will happen or do you want to know what we think should happen?” From mid-July to mid-August, the U. S. stock market had dropped approximately 10% (see chart at right), which would qualify as the first official stock market correction in well over 1,000 trading days. Fears of a housing bust were beginning to trigger fears of an economic recession. Hedge funds and private equity pools were dropping like flies on a weekly basis, and a public outcry of, “Bail us out!” could be heard from Wall Street and Main Street alike. It seemed that the Fed’s consistent answer to most major financial challenges lately had been to lower interest rates and re-liquify, and we believed the Fed was unlikely to change strategies this time, and they did not.

**S&P 500 Index (12/31/01-9/28/07)**



Source: Bloomberg

Simply put, the markets see the Fed as the solution for our financial ailments, but we see the Fed as a big part of the problem. The global liquidity glut that we have been discussing for several years has been created primarily by the world’s central banks, led particularly by the Fed. We do not believe that it is the Fed’s mandate to bail out hedge funds or imprudent residential real estate borrowers that have used massive financial leverage. We also do not believe the government (read “we”) should carry the burden of those who have made irresponsible or bad decisions. For us to pay for this bailout, we will likely be forced to pay higher taxes or resources will need to be diverted from government programs all because people decided to buy houses they could not afford or imprudently speculate in leveraged investments. If you do not let people fail, then that is

not capitalism. We believe in free markets, not rigged markets. People that make risky financial mistakes are **supposed** to go bankrupt or fail.

The largest cost of a government bailout is one that may not be as obvious – that being moral hazard. The best example of moral hazard that we can provide is when people build houses in flood plains. Flood insurance is usually not available to people that build houses in flood plains. However, when the inevitable flood comes and their houses are wiped out, the government consistently seems to come to their rescue to bail them out. Accordingly, people continue to build houses in flood plains. The unintended consequence of a government bailout is that it actually encourages the behavior that got the homeowner into the bind in the first place. We believe that in a free market society, it is important to let speculators fail. The problem with moral hazard is that the next bailout will likely be even more costly than the current one. That is why we believe that the Fed should not have cut rates. By letting the market forces work, the economy would survive a painful but necessary withdrawal from its addiction to lower rates. If the Fed continues the easing it started in mid-September, it likely risks inflating other asset classes. Look at the charts below on gold and soybeans to see the apparent signs of monetary induced inflation. Or maybe we should say to look at the signs of obvious U.S. dollar depreciation (see chart on next page). We believe it is definitely in the Fed’s job description to protect the purchasing power of the dollar, and its report card on this subject is not a pretty picture. In the first eight months of 2007, the consumer price index rose at a 3.7% annual rate and the costs of energy and food are soaring at 12.7% and 5.6% annual rates, respectively.

**Spot Gold Prices (12/31/98-9/28/07)**



Source: Bloomberg

**Spot Soybeans (9/30/04-9/28/07)**



Source: Bloomberg

## U.S. Dollar Index (12/31/01 – 9/28/07)



Source: Bloomberg

Sometimes the best place to look for truly unadulterated honesty is from a recently retired leader because they are free of political pressures or conflicts of interest. In the October 1, 2007 issue of *Fortune* magazine, recently retired Fed chairman, Alan Greenspan, discusses the recent evidence of the U.S. finally coming out of a long-term disinflationary trend. He states, “Cost pressures are beginning to build around the world. This suggests that, longer term, the Fed’s going to have to be tighter. It means that stock prices are going to have some difficulty moving forward.

Shorter term, it’s got problems with very significant credit disruptions and turmoil. [In my tenure] we had a relatively easy task in lowering rates without concern about triggering inflation. I regret that that is no longer the case.” In our opinion, the Fed’s decision on 9/18/07 to lower the Fed funds rate and the discount rate by 50 basis points was more the easy short-term decision rather than the right long-term decision.

## 2007 Equity Performance

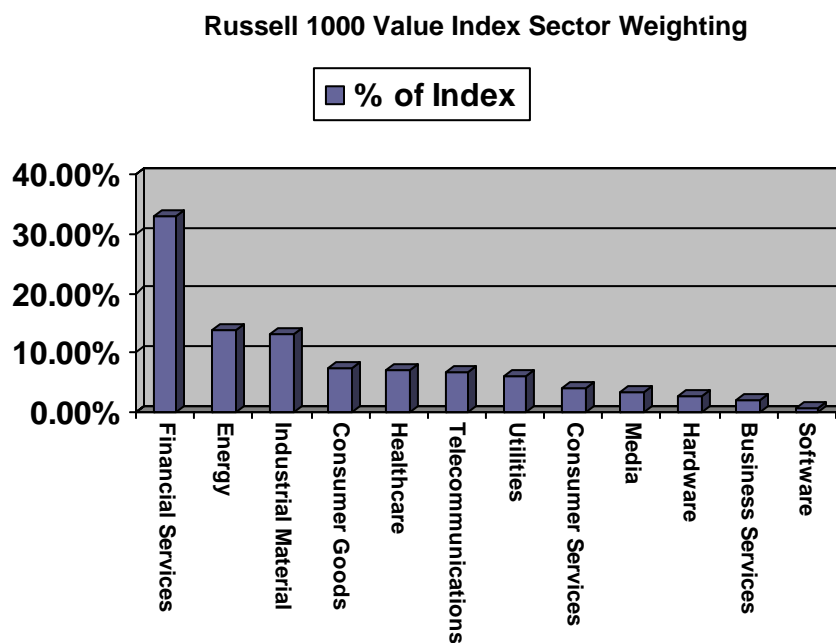
It is highly unusual for us to ever discuss short-term performance. This year there has been a sharp divergence between our clients’ equity performance and that of value benchmarks. Accordingly, we believe that it is important to provide some explanation.

2007 is shaping up to be an interesting year because growth stocks almost universally have been producing superior returns to value stocks. This is the first time in quite a long period that this has occurred. And yet, the equity returns that our clients have achieved this year have been quite strong. Generally speaking, there are two distinct reasons for this outperformance that are important to highlight. First is stock selection. Frankly, we have been fortunate with more than our share of takeovers and merger proposals. **Phelps Dodge, Lyondell, Ohio Casualty, Transocean**, and to a lesser degree, **3Com** have all been additive to performance. It is our job to identify value well before other investors do. It seems that certain hedge funds, private equity pools, and strategic investors have started fishing in our value pond and this has benefited our clients’ equity returns.

Likewise, we own a number of holdings whose marked improvement of fundamentals has been a pleasant surprise. Frequently, we are investing in companies with temporarily depressed fundamentals, and we will be rewarded if their fundamentals only return to normal conditions. Should conditions improve beyond that point, we can participate in even more handsome returns. A great example of that is what the ethanol boom has done for the agricultural community. This is a unique event that neither we nor most other

investors anticipated. Rest assured that it works both ways. There are plenty of negative unforeseen events lurking around as well.

The second, and in many ways the most important, reason for our outperformance so far in 2007 has been sector weightings. This subject is probably even more important when comparing us to our value peers. In looking at the chart below, you will find that the Russell 1000 Value Index, a traditional value benchmark, has a very sizable weighting in financial stocks. This makes sense since many financial stocks (particularly bank stocks) are conventional low P/E, high dividend yield stocks. Our experience is that most of our value peer managers have portfolio weightings of 30%, 40%, and some over 50% in financials. Financial stocks represent approximately 33% of the Russell 1000 Value Index and currently over 20% of the S&P 500 Index, by far the largest sector weighting of each respective index. We, on the other hand, have relatively light holdings of financials, and where we do have holdings in financial stocks, most of our focus has been on very unique property and casualty insurance companies.



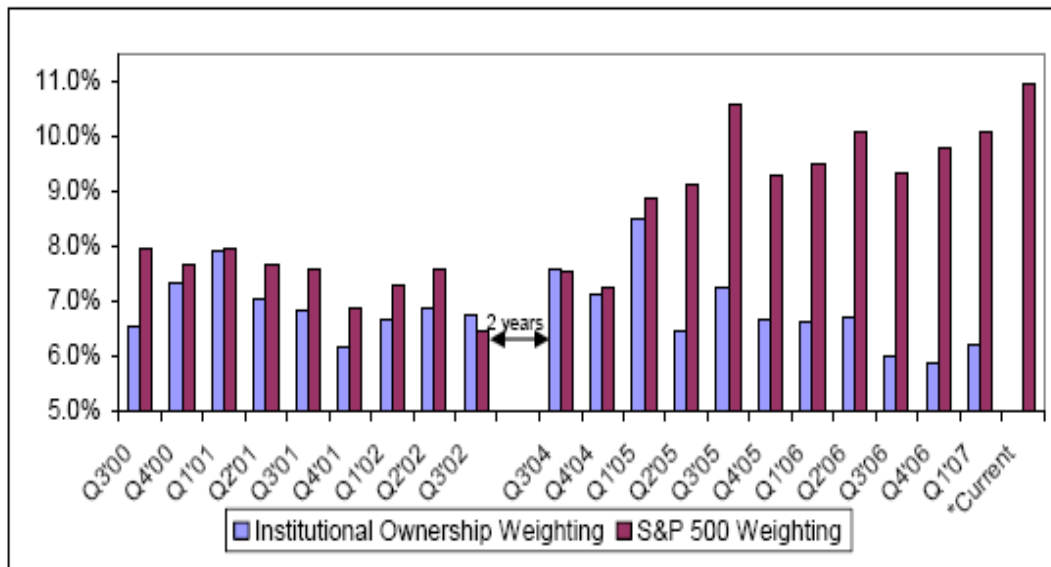
Source: Morningstar

You may be wondering why we are strongly underweighted compared to our value peers in financial stocks. Two quarters ago, we discussed in depth our concerns about the record level of profit margins that existed in the marketplace and the likelihood that these margins would be returning to more normal levels. The financial sector has been the bell cow for record profit margins, and thus, is possibly at greatest risk to see declines in future profitability. We believe that existing valuations in the financial sector are based on unrealistic assumptions of permanently high profit margins, with optimistic growth assumptions as well. Up until very recently, we have been in a “perfect world” for the banking sector with loan loss reserves at a 32-year low compared to total loans according to the 6/30/07 FDIC Banking Profile. Historically, strong buying points for financial stocks have generally occurred when the group has traded around book value. Currently,

the multiples are two and sometimes three times that. Our impression is that the challenges for financials are in the early phase, and the risk premiums demanded by investors are likely to increase.

On the other hand, another area where we generally differ from our value brethren is in the energy makeup of our clients' portfolios. Whereas the energy sector is the second largest sector in the Russell 1000 Value Index, it is by far the largest sector for our clients. Even though energy stocks have provided attractive returns over the last several years, high levels of institutional investor skepticism remain. The chart below reflects that recently energy stocks have made up approximately 11% of the S&P 500 Index weighting but only approximately 6% of institutional investor ownership. Also for the last seven years, periods of generally improving fundamentals and intrinsic values for energy companies, institutional investors have become progressively underweight in energy stocks.

**13(f) Institutional and S&P 500 Energy Weightings**



Current as of 7/4/07

Source: Bloomberg, Thomson Financial, and Simmons & Company International

**Personnel News**

We recently hired Trina Boyd as our Insurance Accounting Specialist to work with our regulated clients. Trina brings to us a wealth of portfolio accounting and systems experience. We are fortunate to have Trina working for us as our business continues to grow steadily.