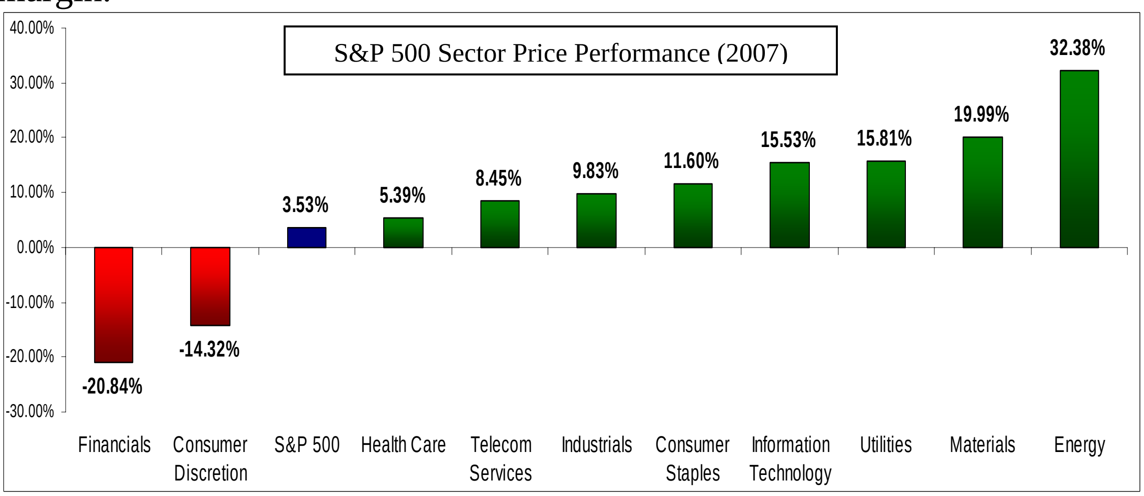
January 11, 2008

Quarterly Commentary

4th Quarter 2007

We are very pleased to report that we experienced an outstanding 2007.

Our equity clients benefited from one of the best years of our careers last year. As we updated you at the end of the third quarter, we were able to combine an underweight position in bank and brokerage stocks with an overweighting in energy, materials, and property and casualty insurance to outpace both the broad market and value benchmarks by a considerable margin.



Source: Standard and Poor's

Our clients have now experienced nine consecutive years where they have outpaced the broad market. It was also the fifth year in a row that recorded returns were much greater than those that can be expected from investing in common stocks over the long-term. For those of you that have been with us this entire period, these results have given a significant boost to your financial profile, and for that, we are very grateful.

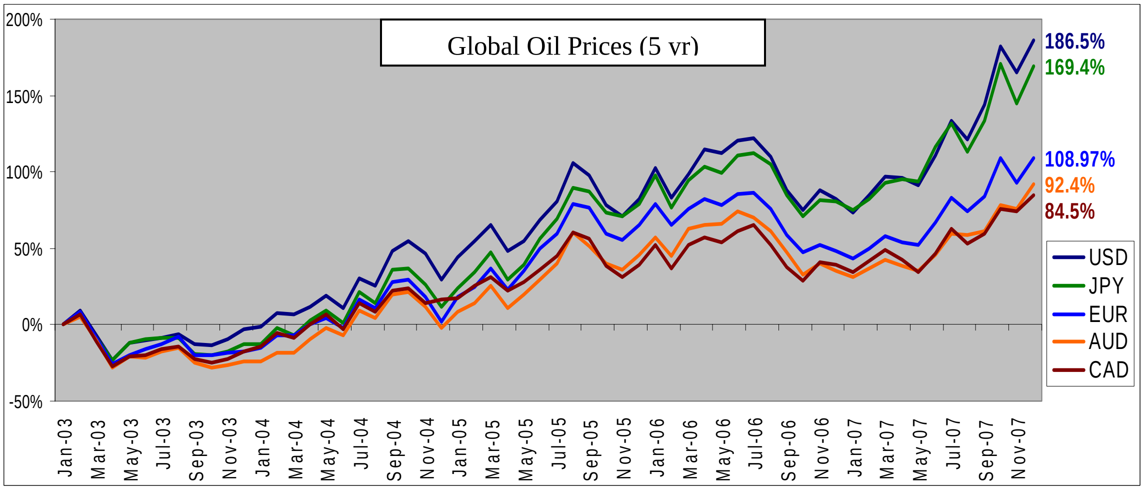
For the last four or five years, we have felt that the next big investment mistakes made by investors would be made in fixed income. We observed fixed income investors stretching for yield by lowering credit quality standards. These mistakes were uncovered in 2007 due to the defaults in high risk or "sub-prime" mortgages. These default events triggered a re-assessment of all asset-backed securities, particularly those related to mortgages. As the sun set on 2007, the assets produced by the structured finance industry (see our 2nd Quarter 2007 commentary) still had a highly uncertain value, and the lack of trading activity in these illiquid assets continued to make the observable, independent valuations necessary for marking to market impossible to obtain.

While we did not hit any home runs in our fixed income performance, we are very pleased that we have thus far been able to avoid the fallout from the debacle described above. Many fixed income investors cannot say that. As we have mentioned before, we feel a good portion of our value as a portfolio manager can come from avoiding the hazards presented by the investment industry. Because we were able to do just that in 2007, we view our fixed income results as a considerable success. We continue to view the fixed income markets as a place that is lacking promise for good long-term returns exceeding inflation and is fraught with potential booby traps where permanent losses of capital might occur.

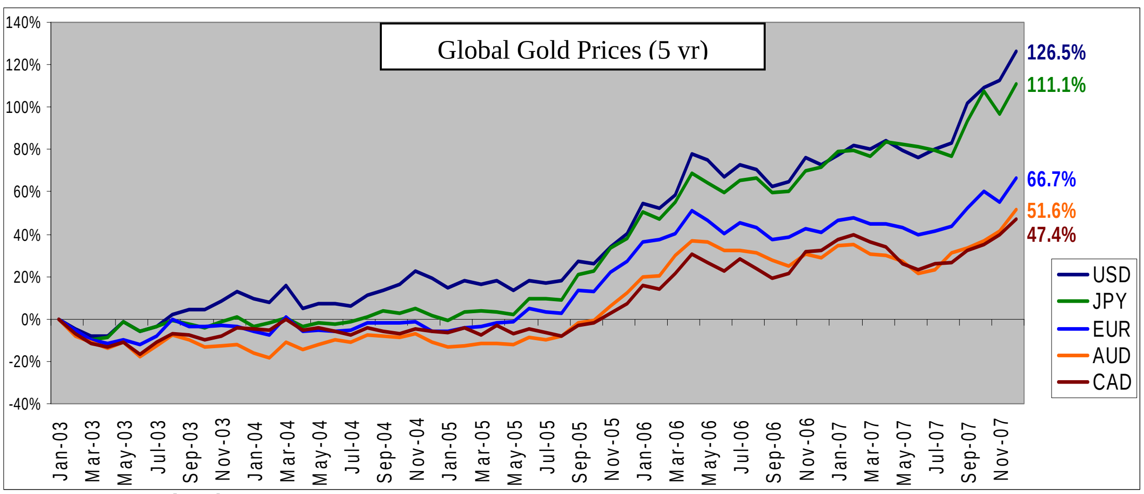
The Dollar Has No Clothes

As we discussed last quarter, the Fed has opted to try to stimulate the economy by lowering the targeted overnight funds rate despite the fact that the dollar has been in decline for the last several years and there is increasing evidence of inflation. Since our last writing, the Fed followed up their initial 50 basis point reduction with two more 25 basis point cuts. Despite the immediate negative impact on the dollar from the first rate cut, the two succeeding cuts were implemented and the policy of the Fed was laid bare for the entire world to see. There was no more pretense that the dollar would be supported.

The debasement of the dollar is having a real impact on the purchasing power and standard of living of our citizens. Intentional inflating on the part of the Federal Reserve is reflected in the dollar prices of oil and gold, which have risen rapidly over the last five years. The two following graphs document that the two countries with the loosest monetary policy over the last five years, the U.S. and Japan, have experienced the most rapid increase in the price of oil and gold. If you lived in Australia, Canada or Europe the price increases you experienced were significantly less, although inflation was obviously occurring there as well.



Source: Bloomberg



Source: Bloomberg

This discussion can be viewed from a different angle, as the *Wall Street Journal* did recently in its' editorial column. They tend to look at the price of gold as primary in sending signals of current and expected inflating. Thus, the rapid price rise of gold is signaling excessive monetary stimulation by the Fed. Had monetary policy been successful in making the dollar "as good as gold" during the last five years we studied, oil prices would currently be around $36/barrel, instead of $96 at year end.

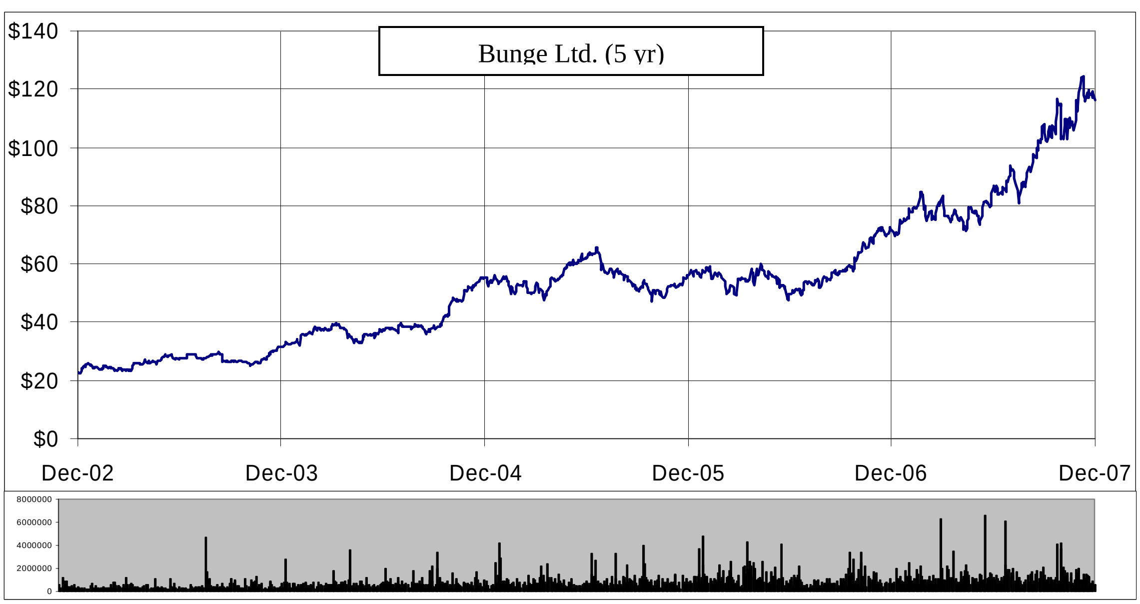
We believe that rapid increases in the price of oil and gold over the last five years are better indicators of inflation than the government's statistics. The Fed under Greenspan and Bernanke has made its intentions clear. The Fed will continue to inflate in an effort to ward off a recession.

When Nixon announced that the U.S. Treasury would no longer redeem U.S. dollars with gold in 1971, he made the famous statement that "we are all Keynesians now." His implication was that it would be up to the federal government to implement fiscal policies that would help the economy through its cyclical tendencies given the new monetary regime of floating currencies. Given the Fed's inflating, if Nixon were alive today we believe he might change his quote to "we are all monetarists now."

True Confessions

One of our most popular quarterly commentaries proved to be the one at the end of 2004 where we divulged several errors of omission, in other words, ideas that were right under our noses in one form or fashion on which we failed to act. We've since accumulated more than enough of these blunders to resurrect this topic. We hope our recent success offsets the pain of reading this.

Bunge is a repeat name from our 2004 group of extraordinary exclusions. In our defense, this was a private company that went public in 2001, and we've never found a lot of promise in initial public offerings. The stock did very little for over a year. After we finally discovered it, we decided it needed to get a dollar or two cheaper for us to buy it. When we wrote about our mistake in '04, we were sure the stock held no promise at that point. It has almost quadrupled since that time. This one is particularly painful because one of us was well familiar with this company having made his living competing against it for seven years.

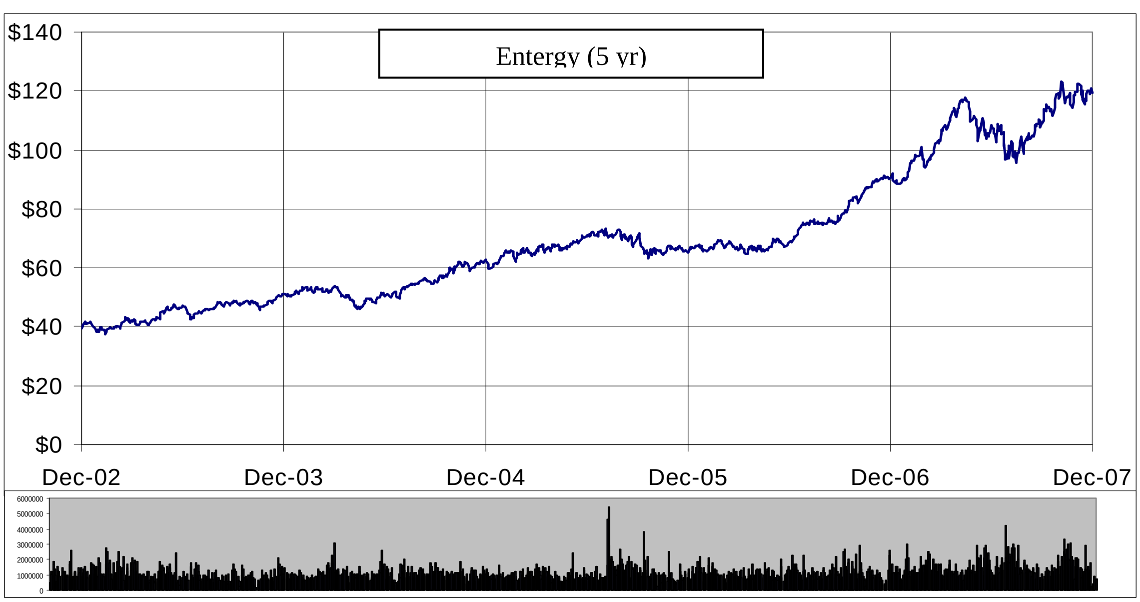


Source: Yahoo! Finance

Monsanto is another agricultural name we slept through, despite the fact that our fearless founder's family had sold a business to this company which operated it in the family name through most of the '90s. We still haven't figured out how we chose to ignore it under $10 in 2003. The company's Roundup Ready soybean seed was a proven technology by that point, enabling farmers to increase their usage of no-till and low-till planting. The stock was obviously a bargain throughout '04 as well. We hope the following chart won't keep you up at night like it has us.

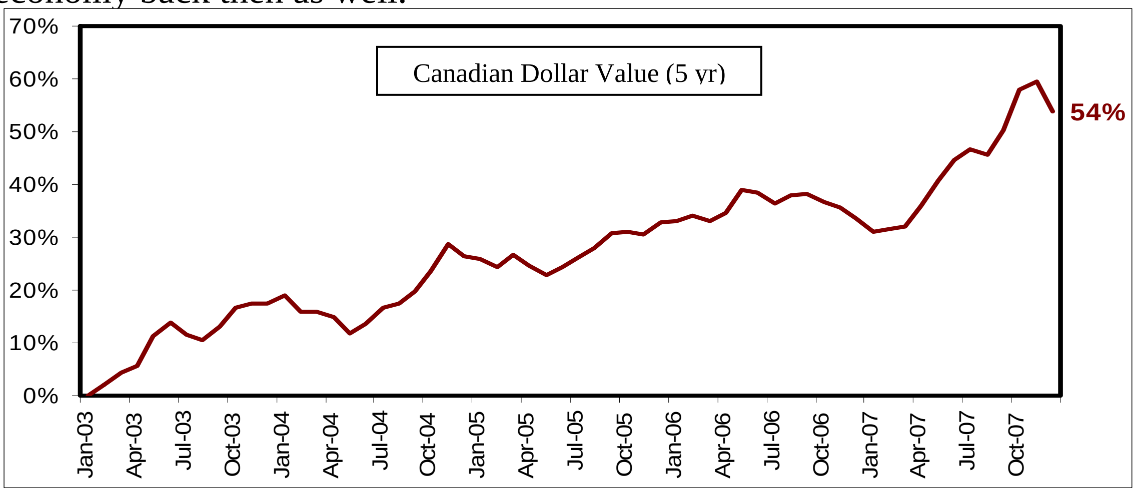
Source: Yahoo! Finance

Speaking of right under our noses, the local electrical utility **Entergy** was another astounding miss. Our bias against investing in regulated businesses (not that we wouldn't at a price) caused us not to know this company as well as we might have. The company's plan to spin off its six unregulated nuclear plants has revealed the asset value to the world. We not only missed it, we never even took the bat off our shoulder.



Source: Yahoo! Finance

Our goof ups haven't been limited to equities. In the late spring of '05, we thought it prudent to diversify our fixed income portfolios by investing in foreign sovereign government bonds denominated in foreign currencies. Having owned several Canadian stocks and having experienced a mild appreciation in the Canadian dollar, we were sure we had missed that opportunity for Canadian government bonds. The chart below supports our assertion that we do not pretend to be currency traders. We went back to '03 to compute what it has cost you, since we were bullish on the Canadian economy back then as well.



Source: St. Louis Federal Reserve

<u>Zach Riley</u>

We are happy to announce the addition of Zach Riley to our staff. Zach received a B.S. in Finance and a MBA from the University of Arkansas (he will definitely add to our average GPA around here). He is a CFA level III candidate and recently worked for Wal-Mart as an analyst. Zach hails from North Little Rock and enjoys many sports, including snow skiing, soccer and all things Razorback. Also, he is a very eligible bachelor at this point.

We close by expressing our gratitude for helping us complete another great year. Your confidence and patience over the years are key ingredients to building long-term success, and we thank you for them. We sincerely wish you and your loved ones all the best for a healthy, happy and prosperous 2008.