



October 7, 2008

Quarterly Commentary

3rd Quarter 2008

As you might imagine, we have had a difficult time focusing on what to discuss in this quarterly commentary due to the overabundance of events that have occurred in the last ninety days. It seems as if a decade of financial events, mostly negative, has happened in the last quarter. Although many of the major occurrences were somewhat predictable and forewarned by us, the magnitude and swiftness of the events have left many investors in shock. We have recently fielded several inquiries from clients wanting to know our thoughts. In fact, our investment team (now four CFA's, up from two) met to discuss whether we should contact our clients several weeks ago when market events seemed to be reaching a crescendo. We decided against it for two reasons. First, we felt that it would reinforce short-term thinking to our clients, and that is a tendency that we always discourage. We knew that our quarterly commentary would be coming out in a few weeks, and we were confident that we could be more thorough in this missive. Second, we have been incredibly busy doing security analysis work. There are many opportunities today that, only six months ago, we thought we would never have the chance to purchase at our required levels. Do you remember last quarter when we said that there were numerous stocks that could provide a 6-7% annualized return, but that we were interested in stocks that could provide a 15% return? Well, guess what! We are now finding stocks that are at or near those levels. Can you hear the tone of enthusiasm in our voice?

You have heard from us over the last several years that, while we were finding certain individual stocks that were attractively valued for projected high rates of future returns, the overall market of stocks was not priced attractively. Valuations for the overall market of stocks were above-average and accordingly, we expected below average future returns for stocks. We did, however, and still do, believe that stocks will provide more attractive returns than bonds. In fast-forwarding to today, stocks are much more attractively priced; hence, we expect their future returns should be much more attractive.

Let us attempt to equate this to real life. When one of us was a tennis playing pre-teen, he wanted a new tennis racquet that would propel him to certain stardom. This young tennis player had done intense research and determined what instrument could make him the best player he could be. A Tad Davis Classic racquet with VS cat-gut strings, the finest of its day, was identified and lusted after for months. Not to be denied, this player worked odd jobs and saved for months trying to raise the money to purchase that racquet. Every time he passed by that racquet in the shop window, he would yearn for it. But this racquet

was still out of his price range. But then one day, that racquet went on sale at an affordable price for the boy and was purchased by the happiest twelve year old on the planet. Now did that boy ask why did the racquet go on sale? Did he ask will the sale last longer and will the discount be even more? Did he ask what do the commentators on MSNBC think? Did the boy trust his research? Was he willing to deploy capital at an opportune time? Did the future return of the asset warrant the purchase price?

Now let us leap-frog to early October 2008. We are now beginning to find much more attractive investment opportunities. For some of our clients that have hired us in the last several years, this is probably the first time that they have heard this tone in our voice. For most of our clients, we are thankful that we have the cash to deploy as opportunities develop before our eyes. Can the market go down from current levels? Absolutely! Can stocks that we are buying today go down after we buy them? You bet! However, for the first time in several years, stocks are beginning to be on sale.

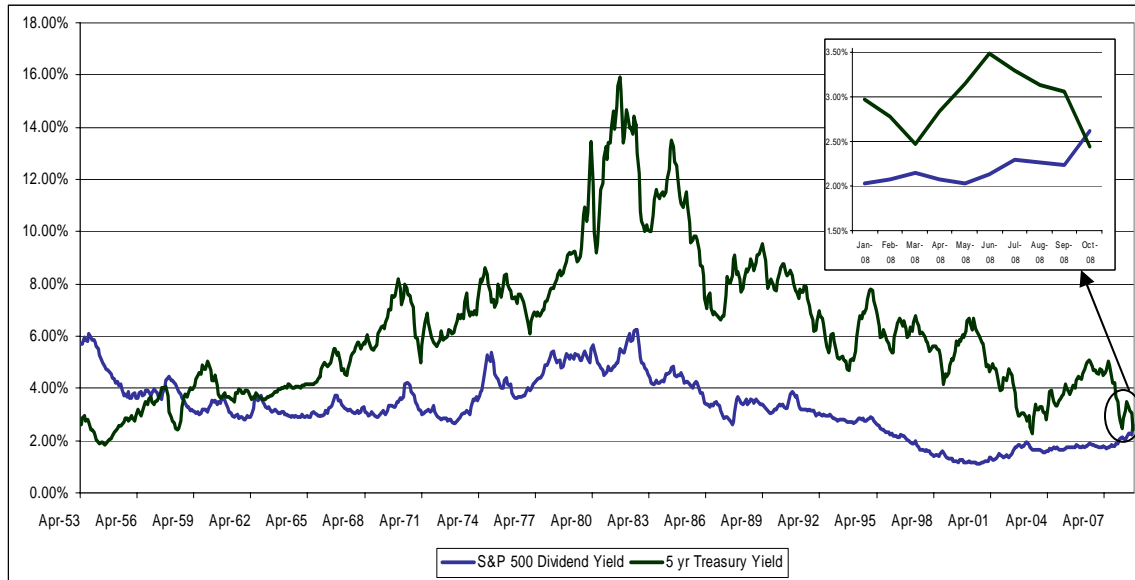
Besides having cash to deploy at times like this, what other ingredient is necessary to be a successful long-term investor? Our answer would have to be conviction. Many intelligent investors are successful in identifying attractive investment opportunities. However, to be truly successful for our clients, we must have the confidence in our research and the conviction to act. We have said before, that many of our best investment decisions have occurred when we felt almost nauseous when we bought them. Without conviction to act, we could let that great investment idea just sit on a shelf.

It can also be the same way when selling. For example, when we sold **Mosaic** for our clients at the beginning of this year for a huge profit, we may not have seemed so smart, as it proceeded to almost double in less than six months after selling it. It is now at less than half of our sale price only three months after reaching its high. We had to trust our research and sell when the stock price exceeded the fundamentals.

Let us share some statistics to put this market downturn in perspective. As we write this, the U.S. stock market is down approximately 24% year to date. Foreign stocks, which were the rage last year with massive amounts of money chasing their previously hot returns, are down roughly 32% this year. Emerging markets, which were the red-hot stock market last year, are down around 40% this year. Junk bonds are actually down 13% this year and municipal bonds have also declined approximately 10% so far in 2008.

There is one area that is hot, and it is hotter than a firecracker. U.S. Treasury securities have risen in price and dropped in yield to previously unheard of levels. Recently, short term T-Bills were priced to yield zero, nothing, nada, zip. Fortunately, for most of our clients, we have had significant T-Bill holdings. As we were selling some of our clients' T-Bills recently in order to buy stocks that we found attractive, we were being questioned by traders, "Are you sure you really want to sell T-Bills? We do not have anyone actually selling T-Bills, only buyers." If you were ever looking for a contrary indicator, this might be it. We were selling T-Bills with yields substantially less than 1% in order to invest in

stocks that have 4-5% dividend yields and we believe good balance sheets to back it up. Interestingly, the current dividend yield for the average stock in the S&P 500 Index is now 2.62% which is higher than the current five year U.S. Treasury Note of 2.44%. It has been a very long time since we have seen this kind of relationship (See Chart Below).



Source: St Louis Federal Reserve; "Irrational Exuberance" by Robert J. Shiller; Barron's

As bottom-up value investors, our focus is continually on investing in businesses. When the investment community hears that stock prices are falling, we hear that the price of owning those businesses is getting more attractive. We take comfort in the fact that we have invested primarily in tangible assets (more than financial assets) in the stocks that we own for our clients. We like the businesses that we own, as they are soundly financed, produce real profits (as opposed to brokerage firms' and banks' false profits, no pun intended), and have growing intrinsic values.

The stock price of a security reflects today's marginal opinion, not the fundamental value of the business. We do not believe, as do most academics, that markets are efficient and that stock prices accurately reflect the fundamental value of a business. Did Mosaic's fundamental business value actually double in six months, only to decline by 75% in less than 90 days? We do not think so. Therefore, our job is to protect our clients from risk and to seek investment opportunities that will provide an attractive return on their capital by focusing on the intrinsic value of their business.

Cash and Equivalents

We believe that, given recent events, this would be a good time to discuss the investment of our clients' cash and equivalents in their portfolios. It is somewhat assuring that the government has agreed to step in, if necessary, should money funds experience additional stress. As we said previously, we have purchased in the last year more T-Bills than

probably at anytime in our collective careers. While we are required to have a certain amount of liquid assets for transactions, we believed that we were being rewarded for holding some of our clients' cash in T-Bills. In fact, of our clients' total assets under management on 9/30/08, we held more than five times the amount of T-Bills over money market funds. We did this because, when we purchased them, T-Bill yields were competitive with money market funds, liquid, and of utmost quality. While this created more work for us by causing us to have to manually buy and sell T-Bills rather than allowing money market funds to automatically sweep, we believed this was the right thing to do in the current market environment. Interestingly, as we have recently sold some of our T-Bills to invest in several attractively priced stocks, we have calculated the return while we held the T-Bills, and it has been substantially more than we would have earned in a money market fund during that same period. That is due to the rapidly declining interest rate environment into which we have been selling.

Our Opinion of the Government Bailout

We are free market (laissez faire) proponents. We always prefer for markets to clear naturally rather than artificially. A case in point would be the government's decision to restrict temporarily the practice of short selling in select financial stocks. There has been little evidence that this effort has moderated the decline of financial stocks. This is a classic example of artificial market manipulation. We believe the free market can smell this kind of manipulation from a mile away and often creates unintended consequences. We feel the same way about the pending proposal to amend mark to market accounting. We believe the knowledgeable investor will likely see through the smoke should this accounting practice be lifted. In our mind, lowering the bar of accountability for financial institutions is not an effective way to resolve our financial challenges.

We believe the government is mostly to blame (along with Fannie Mae and Freddie Mac) for the economic conditions and challenges before us today, particularly in the area of real estate lending. We are skeptical that the government can and will solve these issues effectively. However, since the government has determined that it must act, we would anticipate that the economic downturn might be slightly less painful in the near-term, but the recovery will likely be postponed into the future. What we are most concerned with is the moral hazard being created for the future by this bailout. It seems whenever artificial safety nets are created, increased risk taking is not far behind. This situation reminds us of the Japanese banking crisis of the 1990's, which has now been labeled the "Lost Decade." Had their government allowed the market to clear naturally, Japan would likely have exited their recession much quicker. We are also concerned that there may be numerous negative unintended consequences from the bailout that many of us have not even considered. Sometimes the medicine can be worse for the patient than the affliction.

What we are confident of is that this government bailout is inflationary. While many investors, including the bond market, are arguing that it will be deflationary, we see quite the opposite. We believe the government is printing money as it has rarely printed it

before. However, one has to look a little closer to see the evidence. Since the growth rate of the Federal Reserve's balance sheet has recently been modest, where is this evidence? U.S. Treasury and Reserve Bank credit is where money creation is occurring. By assuming or monetizing liabilities, the Treasury and Federal Reserve have expanded government-guaranteed debt at a breathtaking rate. They are creating money out of thin air almost on a daily basis. Whether it is Fannie Mae or Freddie Mac to the tune of \$5-6 trillion, or the government bailout for \$700 billion, or guarantees for money market funds for \$450 billion, or AIG for \$85 billion (this sounds like a high stakes Jeopardy game), or other previously unheard of government loans and guarantees, the government is printing money before our very eyes. What we are confident of is that the federal government's liabilities have skyrocketed. Never before has our fate been in the hands of so many foreigners holding so many dollars, which are the reserve currency of worldwide commerce. It concerns us that a strong dollar and low inflation policy have fallen down the list of the Fed's priorities.

So where is inflation manifesting itself today? Unequivocally, government bond prices would be our answer. There has been a sudden flight to quality toward U.S. Government securities in this anxious market environment, hence the recent questioning from the traders when we were selling T-Bills. While yield spreads for corporate bonds have been widening in comparison to government bonds, this has as much to do with lower government bond yields as higher corporate bond yields. While high-grade corporate bond yields have recently risen, their absolute yields are still somewhat on the low side. Low U.S. Treasury yields are promising negligible returns, particularly after inflation and taxes.

Investment Team Update

In August, we hired Chris Fleischmann, CFA to come work with us in the areas of security analysis and portfolio management. Chris has experience as a value equity portfolio manager, and we are pleased to welcome him to our investment team. Chris, his wife, Karen, and their two young sons, Blake and Ian, have moved to Little Rock from Memphis. Hopefully, you will have the opportunity to meet Chris in the near future.

In the same week that Chris Fleischmann was hired, we received the good news that Zach Riley had successfully completed the third and final leg of the CFA program. Congratulations, Zach!