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2007 in Review: Trench Warfare

Stock trading in 2007 resembled trench warfare. Prices fluctuated wildly day-to-day but remained in a narrow 13% range for the year as a whole. Twice, the S&P 500 advanced more than 10%. Twice, the advances were followed by 10% corrections. The intensity of the struggle was epitomized by the 66 trading days on which the index closed 1% higher or lower. This compares to 29 such days in 2006 and 32 such days in 2005.

We believe the intense mood swings reflected an unusually high level of uncertainty regarding inflation, earnings, oil prices, globalization, mortgage-related fallout and other issues. These uncertainties have not been resolved. These issues and our investment position follow:

- Inflation: The Consumer Price Index advanced 4.2% between December 2006 and December 2007. The “core” CPI, which excludes “volatile” food and energy prices, advanced 2.2%. What rate should investors use when valuing stocks and bonds? When inflation is between 2.5% and 3.5%, the S&P 500 is historically valued at 17.6 times earnings. When inflation ranges between 3.5% and 6.5%, the S&P is valued at 13 times earnings. Meanwhile, 10-year Treasury bonds usually yield 2% to 3% more than the rate of inflation.

Using a 2008 inflation range of 2.5% to 3.5% and Goldman Sachs' \$95 earnings estimate for forecasting purposes, year-end interest rates of 2.8% and 4.1% on 2-year Treasury notes and 10-year Treasury bonds are unappealing as are the rates on many taxable bonds. The S&P 500 has mid-teens upside from year-end levels. The Value Line Composite appears marginally undervalued at best. Higher inflation and/or lower earnings represent downside risks to these forecasts. Lower inflation and/or higher earnings represent additional potential.

- Corporate earnings: 2008 operating earnings estimates for the S&P are all over the map. They range from the low-\$80 range to more than \$100. These earnings estimates reflect economic predictions ranging from deep recession to healthy growth.

Although we have limited confidence in aggregate earnings predictions, we have a high level of confidence regarding earnings for our holdings. According to Value Line, our median holding ranks in the 85th percentile (100 is highest) for earnings predictability. While predictability is usually associated with above-average valuation, our holdings collectively trade at significant discounts to historical norms. On average, our stocks historically sell at 120% of the p/e multiple of the Value Line Composite compared to today's 90%. We believe this discount represents upside potential and downside protection.

- Oil prices: Oil rose from \$61 per barrel to \$96 per barrel in 2007. OPEC ministers and some other observers believe that speculators are keeping the price \$20 to \$30 per barrel above equilibrium based solely on supply and usage. Others believe the price will soar above \$100 as inexorable demand from developing economies like China and India overwhelms supply that is verging on decline.



While we are hesitant to predict where oil will trade in the short-term, we believe the long-term trend is higher. There is little evidence that oil production can increase meaningfully over today's levels. We expect to maintain a core position in energy and/or energy services. We own other stocks that benefit indirectly from higher oil prices such as railroads – which are inherently more fuel efficient than trucks – and auto companies with product line-ups oriented toward fuel efficient cars rather than gas-guzzling pick-ups and SUVs.

- The mortgage mess: As distressed homeowners turn into foreclosed sellers, the supply of houses for sale increases. Meanwhile, tighter lending standards shrink the pool of prospective buyers. The result is falling prices. Estimates of mortgage loan losses run as high as \$500 billion. Because so many mortgages were securitized – originated by Company A and put in packages sold to Investor B – nobody knows exactly what is in the bag or who is holding it. This makes securities analysis of large swaths of the market extremely difficult.

When uncertainty is high, the investment baby is often thrown out with the bathwater. We constantly evaluate the risk exposures of our financial services investments and compare the stocks we own with the stocks we don't. We believe our current financial services holdings represent a reasonable fraction of our portfolio, have a high degree of diversification from one another and have favorable risk/reward characteristics.

- Consumer spending: U.S. consumer spending has been supported by MEW – mortgage equity withdrawals. With house prices falling and lending standards tightening, MEW is grinding to a halt and consumer spending is slowing.

Among retailers, the best groups during recessions have been drug stores, discount stores, auto parts and pet stores. Our current and contemplated retail exposure falls within these groups.

- Global (de)coupling: Is it still true that the rest of the world catches pneumonia when the U.S. economy catches cold? Some believe the world economy can grow through a U.S. slowdown or recession. Others believe a U.S.-led global recession is imminent.

We believe international business is a plus. The stocks in our portfolios receive approximately 43% of revenue overseas.

- Credit crunch: In a normal economic cycle, the Federal Reserve Board raises interest rates to slow economic growth and tame inflation. As credit gets more expensive, borrowers pull back. When growth slows too much, the Fed reduces interest rates and borrowers become more active. Following the usual playbook, the Fed has cut interest rates three times since September. There is wide disagreement as to whether these cuts will keep the economy out of recession.

In the current cycle, tighter lending standards are more of an impediment to borrowing than higher interest rates. No-down payment, no-documentation mortgages are not available at any interest rate. Covenant-lite private equity financing is gone with the wind. The usual cure for a slow U.S. economy is not going to work as it has in the past. Asset prices, more than interest rates, must adjust downward. For this reason, we have not owned homebuilders, monoline mortgage originators or monoline guarantors since 2005.

- Japan syndrome: In the early 1990's, the U.S. and Japan both faced asset bubble deflation. The U.S. created the Resolution Trust Corporation to seize bad real estate assets and sell them expeditiously at fire sale prices. The savings and loan crisis soon passed. The Japanese allowed banks to carry bad assets at inflated values. The malaise lingered for a decade. Banks could not make new loans since their capital was tied up in bad loans. Bad assets overhanging the market discouraged new investment.

The U.S. runs the risk of repeating the Japanese experience if a moratorium on interest-rate adjustments or foreclosures keeps ostensible real estate prices above their market clearing price. Any action that postpones price adjustments will prolong the problems in lending, housing and consumer spending. While there has been more talk than action on this front, we will re-evaluate our investment posture as needed.

- The 2008 election: Speculation about political change will loom larger as 2008 wears on. Policies regarding healthcare, taxes and the war in Iraq will be front and center.

We believe healthcare reform, if any, is likely to be incremental. Meanwhile, demand for healthcare increases as the population ages. This demand, outside of elective procedures, is resistant to economic slowdowns. While we reduced our healthcare holdings due to unfavorable clinical events, we maintain positions where the risk/reward balance seems favorable.

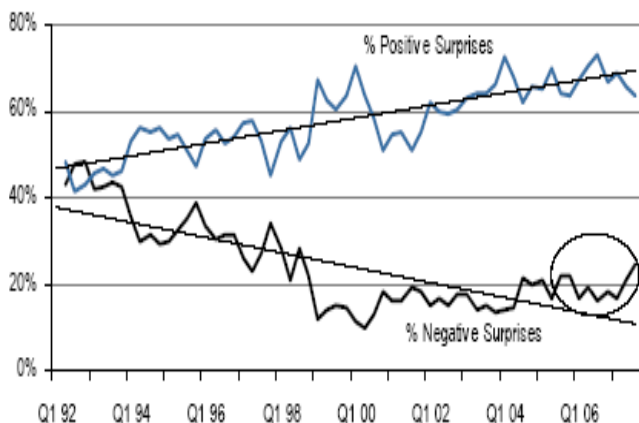
We believe a compromise will be reached on estate taxes but the 2001 and 2003 income tax rate reductions are likely to expire in 2010. Everything else being equal, higher tax rates on dividends and capital gains will be negative for stocks and taxable bonds. In selected instances, we have begun to factor the possibility of higher rates into our decision-making.

We believe the war in Iraq will wind down. Defense stocks are likely to perform poorly. We sold our lone direct holding last year.

The Quality Trade

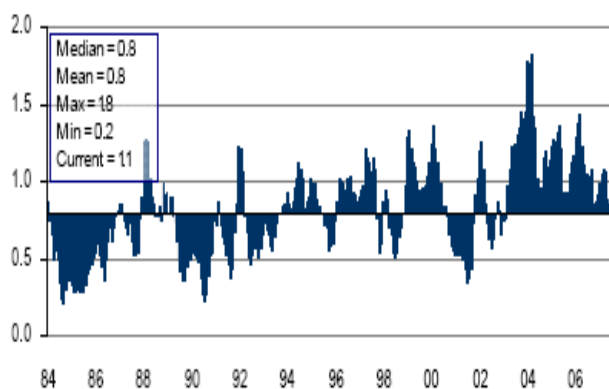
The charts below show why we continue to believe that high quality stocks with predictable earnings growth should lead the market. Chart One shows that negative earnings surprises have been increasing and while positive surprises stagnate. Chart Two shows that the Merrill Lynch earnings revision ratio extended its unprecedented string of positive readings in 2007. It seems clear the current trend in surprises will eventually lead to a negative revision ratio. When negative revisions predominate, stocks with predictable earnings growth are prized. Our best relative performance has come during periods of negative ratios.

Chart 1 : Percent of S&P 500 Companies Reporting EPS Surprises (Q1 1992 thru Q3 2007)



Source: Merrill Lynch Investment Strategy, Thomson Financial

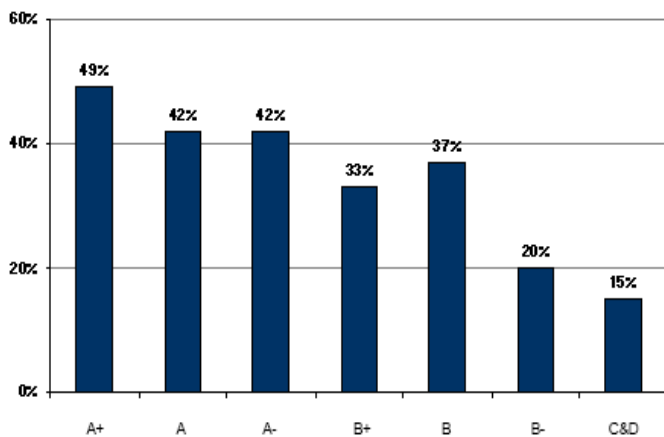
Chart 2 : Ratio of Up-to-Down Merrill Lynch Estimate Revisions (No. Revised Up Divided by No. Revised Down, Rolling 3-Month Basis)



Source: Merrill Lynch Investment Strategy

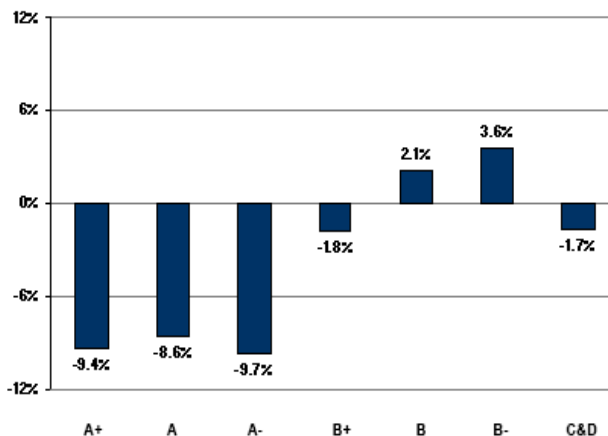
Chart Three shows that quality stocks – those rated A- or better by S&P and covered by Merrill Lynch – historically outperform B+ and lower rated stocks when the profit cycle decelerates. The profit cycle decelerated dramatically in 2007. Nevertheless, as Chart Four shows, stocks rated A- or better *lost* 9% and were the worst performers in 2007. Given the fact that 17 of our 20 rated stocks are A- or better, we hope to swim with rather than against the tide in 2008.

Chart 3 : Average Performance by Quality When the Profits Cycle Decelerated (Last Four Cycles)



Source: Merrill Lynch Investment Strategy, Standard & Poor's

Chart 4 : MLQS Quality Indices Year-to-Date Price Performance as of 12/31/07



Source: Merrill Lynch Investment Strategy, Standard & Poor's

If, as we believe, the decelerating profit cycle extends into 2008, A- or better stocks should outperform the averages. If we can again outperform the A- or better group, we can have double-barreled success.

Summary

The uncertainties that whipsawed the financial markets in 2007 will linger into 2008. We have tried to position our portfolios to produce excellent returns if the outcomes we deem most likely materialize and acceptable returns if they do not. Our base case calls for limited growth in corporate earnings and controlled inflation. Among our individual holdings, some will do better if oil prices rise; some will do better if prices fall. We have significant holdings in areas that are relatively immune to consumer spending such as healthcare and data processing. We have significant international exposure as a hedge against a U.S. recession. We own selected financial services stocks where we believe the risk/reward ratio is favorable. We continue to believe that high quality stocks with predictable earnings will regain their traditional premium valuations. Higher than expected inflation and/or lower than expected corporate earnings represent prime risks to the financial markets.