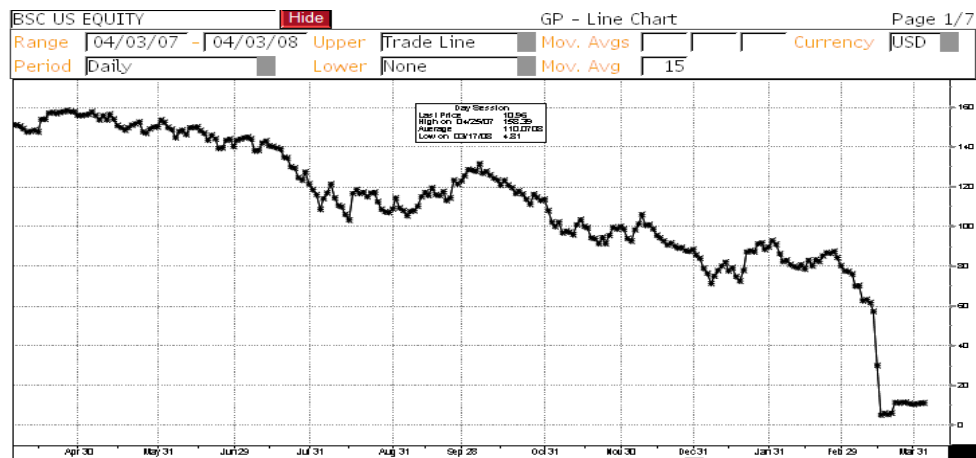


Commentary - 1st Quarter 2008

The first quarter of 2008 will most likely become a milestone in the development of the U.S. financial system. The move by the Federal Reserve to rescue Bear Stearns and take Bear's riskiest assets onto the Fed's balance sheet will have major implications for future regulation of the financial markets and their biggest participants. Much as the wave of bank failures in the 1930s led to the development of the Securities and Exchange Commission, the Glass Steagall Act to separate commercial banks from investment banks, and the Federal Deposit Insurance Corporation, the current situation may lead to a very significant "reformation" of the financial markets. The use of leverage in the financial system has expanded since the early 1980s. As investors' confidence in their ability to manage risk increased, so did their use of leverage. This increased use of leverage applied especially to the big investment banks and hedge funds. Commercial banks could not participate directly in this game since they faced capital ratio requirements from the banking regulators. But that did not stop them. The big money center banks figured out ways to play this game in off-balance sheet entities where they could supply some of the funding and earn fat fees while the investors in the off-balance sheet entities took most of the risk. The subprime mortgage fiasco ended this period of excess leverage because of the lack of transparency of investment portfolios and the inability of computer models to predict the risks involved in many of the new types of mortgage securities. The disappearance of liquidity in the mortgage markets led to the demise of Bear Stearns. As you can see in the graph below, Bear's share price fell from \$160 to \$2 over the last twelve months. The last sixty dollars of their share price decline occurred within one week as other securities dealers refrained from doing business with them.



Bear reportedly had leveraged their capital over 30 times when the liquidity crunch hit and could not sell securities at reasonable prices to meet their obligations. So the Fed stepped

in and arranged for JP Morgan to acquire Bear Stearns after the Fed agreed to take on \$30 billion of the riskiest assets. (The Fed was acting on behalf of you and me.) The reason the Fed decided it was necessary to make this move was not to bail out Bear Stearns shareholders, they received very little consideration. It may not have been to protect Bear Stearns' debt holders, even though debtholders will benefit from the deal as they now are a creditor of JP Morgan. But the main reason was because Bear was the counterparty on untold billions of interest rate swaps, credit default swaps, and other derivatives that are not regulated. Many of these swap instruments are supposedly used to hedge risk, but since they are not highly liquid and transparent, the regulators have a difficult time assessing the risk involved. Now that is all going to change since the Fed took the risk to support an investment bank to keep it from failing. The U.S. Treasury announced its initial proposal on restructuring the regulatory regime for the financial markets and U.S. banks this week. There will be many political discussions on how best to accomplish this goal, but the financial markets are already enforcing a new regime. All leveraged investors will have to maintain higher levels of liquid capital. Greater levels of transparency and liquidity will make our financial system stronger.

Over the last twenty-five years, there has been consistent growth in the use of leverage. That build up of leverage is being unwound at a very rapid pace. We think there will be some very important results from this deleveraging. First, the financial system will be stronger. Second, the growth in the money supply will be slower due to a contraction in the multiplier effect. The dollar will strengthen as money supply growth slows and the financial system strengthens. A stronger dollar will lead to a drop in speculative activity in commodity prices and lower inflation. If we are wrong about the tougher regulatory environment and the requirement for financial institutions to improve their capital ratios and transparency, then the Fed faces a much bigger problem next time. The demise of Long Term Capital Management in 1998 was a wake up call to the regulators that the use of enormous leverage can threaten the financial system. The regulators trusted the financial market participants to police themselves to make sure that situation was not repeated. Unfortunately, the focus on short term profits and greed outweighed the need for stronger compliance. The Fed was complicit by keeping interest rates too low for too long. Let us hope that this financial market crisis leads to stronger measures to oversee derivatives and off-balance sheet entities.

The market began the second quarter of 2008 with a nice three percent gain on April Fools Day after miserable a performance during the first quarter. In the first three months of the year, the S&P 500 Index declined almost ten percent. Many foreign markets were down much more than our markets. The only safe haven was U.S. Treasury securities. We believe the Fed has made the right moves to lower interest rates and provide liquidity to the financial markets. The monetary stimulus and the Federal tax rebates should help the economy recover though we do not expect a rapid return to growth. Banks are still very cautious in

their lending and many will have to raise additional capital before they can grow their balance sheets again. But as we saw with Lehman Brothers this week, investors are willing to commit capital to financial intermediaries if they believe management has been open about their situation. (Lehman raised \$4 billion through placement of a convertible preferred issue.) There is more than \$3.5 trillion parked in money market funds currently, and a substantial portion of that will flow into riskier assets when investors believe the market has stabilized.

Here is how our various strategies performed during the volatile first quarter.

Blue Chip Strategy: Our large cap stock strategy fell 6.72% in the quarter versus a decline of 9.47% in the S&P 500. The financial sector weighed on the portfolio with Citigroup down 26.3%, AIG down 25.5%, and American Express down 15.6%. The weakest performer in the Dow was Merck. They declined 34.3% with much of that coming on the last day of the quarter when an advisory group suggested that their cholesterol drug was not any more effective than other treatments. The best performer during the quarter was Wal-Mart, who gained 11.4% as investors perceive they will benefit from a struggling consumer seeking lower priced goods. We experienced the first turnover in the portfolio since 2004. Bank of America and Chevron replaced Altria and Honeywell. Altria, otherwise known as Phillip Morris, spun out Kraft in 2007 and recently separated their international tobacco operations. Honeywell was the smallest company by revenue and earnings in the Dow. By adding Bank of America and Chevron, the Dow will be weighted more like the S&P 500 Index. Large cap stocks continue to benefit from the weak dollar and once the financial sector stabilizes, we expect performance will be impressive.

Small Cap Value Strategy: Our small cap stock portfolio was our best relative performer during the quarter which is kind of ironic since it should be our most volatile asset class. Our small caps actually were breakeven for the quarter versus a decline of 9.90% for the benchmark Russell 2000 Index. The best performer in the portfolio for the quarter was Arkansas Best, the trucking company we purchased in December. It gained 46% in the first three months of the year after stating in their earnings announcement that freight volumes were improving. The weakest performing position was Sierra Pacific Resources, the utility that services Las Vegas and most of Nevada. Their fourth quarter earnings report did not meet analyst expectations, and their shares were down 25% during the quarter. We sold half of our position in Universal Virginia Corporation, a tobacco wholesaler, for a 75% gain in March. We added a new position in PRG Schultz in January. PRG Schultz is an audit recovery firm that audits firms' accounts payable to see if a company was overcharged or made an overpayment. They are especially active auditing health care insurance claims. They are in the running for a regional contract from Medicare after providing demonstration services to show that Medicare could recover substantial amounts for incorrect billings. We expect small cap stocks to show strong performance when the market rebounds.

Convertible Securities/High Yield Strategy: Our high yield convertible strategy was our most disappointing asset class strategy during the quarter. The strategy fell 9.73% versus a decline of 5.04% in the Merrill Convertible Index and 2.98% in the Merrill High Yield Index. High yield bonds performed poorly during the quarter as the credit crunch made investors nervous that low credit quality companies would lose access to capital and be unable to refinance their borrowings and lower cash flows from a weak economy would result in more defaults. Whereas high yield bonds offered 2.5% additional yield versus Treasury bonds last summer, they now offer 8.0% additional yield. The market is priced for a substantial increase in defaults. At some point, when the financial markets stabilize, investors will begin to take on risk again, and they will be well compensated for taking on credit risk. The best performing position in the strategy was Callon Petroleum, a common stock position we have as a result of conversion of a preferred stock issue. Callon has a large natural gas field under development in the Gulf of Mexico and found a partner to help cover the development costs. The weakest performer was our position in Thornburg Mortgage convertible preferred. Six weeks ago this looked like a great purchase. Then the mortgage backed securities market fell apart. High quality mortgages backed by Fannie Mae and Freddie Mac suffered severe price declines as investment banks dumped their inventories and buyers went on strike. Thornburg is known as a very strong underwriter of mortgages. In fact less than 0.50% of their outstanding loans are past due. However, they were not hurt by credit problems, but liquidity problems. The value of mortgage backed securities declined, even while the value of Treasury bonds was rising, because of the fear in the marketplace that the sub-prime mortgage default problem was going to result in more declines in home values. Bear Stearns suffered from this fear as well as Carlyle Capital - who went out of business. Thornburg was not able to meet margin calls by their lenders and was forced to raise more capital to stay in business. The cost of raising the capital was severe dilution to our position. The company successfully raised capital and we should see some recovery in our position as the mortgage market returns to normal valuations. The near term outlook for the high yield sector is fragile as investors are worried about the economy and the availability of capital. Once financial institutions can raise more capital and stabilize their balance sheets, we should see normal lending resume and the current valuations in the market will attract buyers. Eventually this will be seen as a long term buying opportunity.

Intermediate Bond Portfolios: Our taxable bond strategy gained 1.56% during the quarter versus a gain of 3.16% in the Citigroup 1-10 Year Govt./Corp. Index. We were underweight Treasury bonds and overweight corporate bonds versus the index during the quarter and as stated above, Treasuries were the place to be. As the credit markets settle down, our corporate bonds will outperform. Our tax exempt bond portfolios gained 0.46% during the quarter while the Merrill 3-7 Year Insured Bond Index gained 1.84%. We have added longer maturity tax exempt bonds to our portfolios over the last six months because municipal bonds are extremely attractive versus taxable bonds. The insurance companies that insured many municipal bonds have lost their financial strength due to their commitments to back some

collateralized debt obligations backed by subprime mortgages. This deterioration in the municipal bond insurers has been reflected in a drop in value of municipal bonds to the underlying credit rating of their issuer rather than the rating of the insurer. The leveraged investors in this market were forced to liquidate positions as the market value of their securities dropped to reflect the new lower credit quality. We have not seen dislocations like this in the municipal bond market during our careers. We are actively adding tax exempt bonds to our portfolios for taxable accounts that have a bond allocation. Again, as the credit markets settle down and the de-leveraging process runs its course, we will see substantial improvement in the market values of our longer term bonds.

We appreciate your support during this volatile quarter. We expect this period of volatility will produce many stories for the history books. The demise of Bear Stearns may be seen as a watershed event. Our goal is to protect the value of your portfolio as much as possible during these times while positioning it for the expected recovery.