

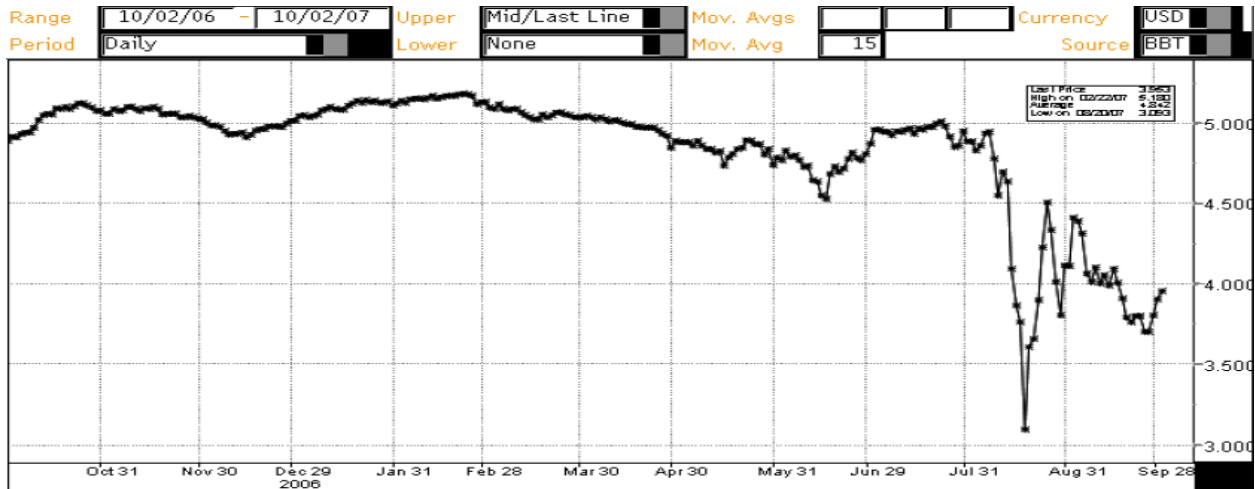
Commentary - 3rd Quarter 2007

What a difference one quarter makes. Last quarter we discussed liquidity in the financial markets and how an ample supply of liquidity was supporting strong performance in the stock market. Well, in less than thirty days from the end of the second quarter, liquidity dried up; and financial markets faced the potential failure of many firms exposed to residential mortgage lending. Our staff has experienced three major banking system events in our investing lifetime. The first occurred in October, 1987 when the stock market plunged 22% in a single day. Ten Year Treasury notes traded with a difference of 5% between the bid price and offer price. (And this was the most liquid market in the world.) The Fed flooded the banking system with liquidity and a crisis was averted. In the fall of 1998, after the Russian debt default, the Asian contagion hit and Long Term Capital Management, a highly leveraged bond hedge fund collapsed, and again Treasury bonds traded with huge spreads between the bid and offer. It was difficult to even get a bid price on corporate bonds if you needed to sell. The Fed came to the rescue again by arranging a bail out of Long Term Capital Management by a group of money center banks. This rescue avoided the forced liquidation of bond positions that were held as collateral by the banks against the hedge fund's borrowings. Now, nine years after the Long Term Capital blow up, derivatives and hedge funds again caused a major crisis in the financial markets. We wrote in January about the proliferation of derivatives and the risk the financial system faced if these derivatives started to disintegrate. The subprime mortgage problem that we discussed in our last letter turned into an avalanche of losses for investors in funds that purchased collateralized mortgage securities backed by subprime mortgages. The two Bear Stearns hedge funds that failed in early July were just the tip of the iceberg. For most of August, if you needed to sell a mortgage backed security, there was no bid price available. Banks tightened lending standards and began asking for more collateral against the credit lines they had outstanding. A French bank closed two of their bond funds from redemptions because they could not value the securities in the funds. A full scale panic ensued as Treasury Bill prices skyrocketed and mortgage backed securities prices plummeted. A graph of the three month U.S. Treasury Bill on the next page shows how volatile the prices of these safe securities became when investors did not care about the return on their money but the return of their money.

The Federal Reserve under a new chairman, Ben Bernanke, took a different approach. Instead of flooding the system with liquidity, they lowered the discount rate and encouraged banks to borrow directly from the Fed if they needed liquidity. This approach seemed to calm the markets. The Fed did not want to be viewed as bailing out the investors who made poor decisions by purchasing subprime mortgage securities, but at the same time they did not want the problems with subprime mortgages to disrupt the rest of the economy because of a credit crisis. Eventually, the extremely weak employment report for August caused the

Fed to lower the Fed Funds rate at their September meeting by fifty basis points. This aggressive move caused a sharp rally in stock markets worldwide. Once again the financial markets learned a lesson in liquidity.

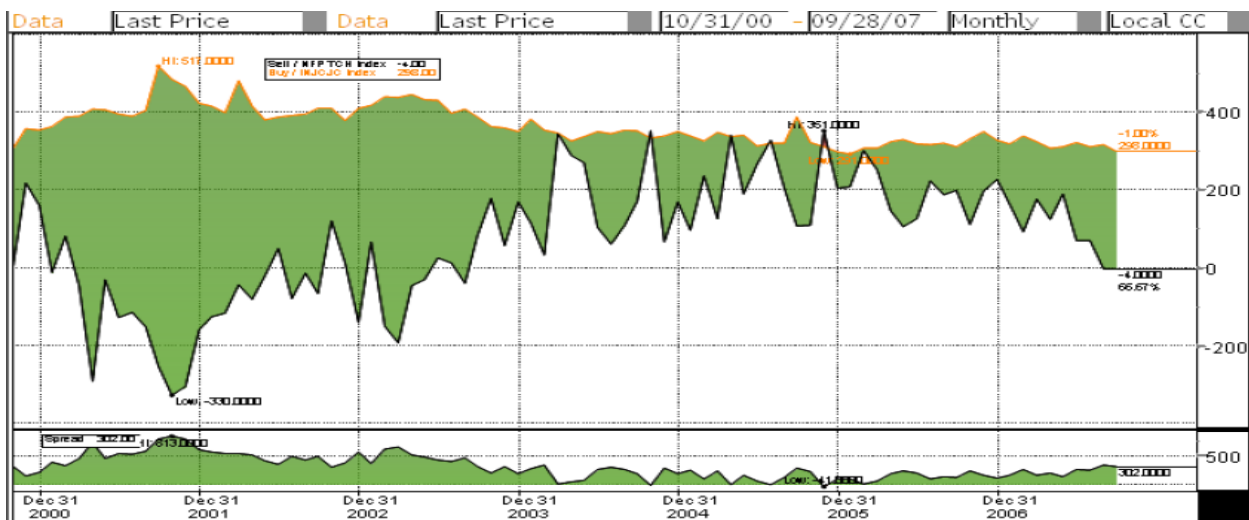
Graph 1. Three Month U.S. Treasury Bill Yield Graph, Source: Bloomberg



Most recessions occur due to an unforeseen event. The Oil Crisis in the seventies, the S&L mess in the late eighties, and the technology stock bubble bursting combined with 9/11 in 2001. The housing sector slowdown has been predicted by many economists and some are even saying that the housing decline will push the economy into recession. However, since it is so widely publicized, many banks have cut back on the available credit to builders and builders have tried to keep inventories from getting out of hand. The credit crunch worsened the housing problem, but that may not tip us into recession. Unfortunately, another policy decision may give the extra push to finally cause the much anticipated recession. This policy snafu is the crackdown on illegal immigrants. We wholeheartedly support the efforts to police our borders and keep track of foreigners entering our country. But the reality is that there is a large population of undocumented workers in the U.S. that make our economy operate smoothly. Agriculture, construction, oil and gas drilling, and food service all depend on immigrant workers. Some states are cracking down on illegal immigrants with legislation similar to what was passed in Oklahoma last Spring. And now the Feds are flexing their muscles with a new program to verify Social Security numbers submitted by employers. If employers are found to have illegal immigrants on their payroll they face expensive fines. Between the state and federal efforts, many immigrants are going to transition to a black market for their services or leave the country. Is this why the August payroll report showed an unexpected drop in payrolls while the filing for new jobless claims still indicates strength in employment? The graph below shows how the weekly jobless claims numbers have remained in the range that supports positive economic growth while the non-farm payroll report shows a precipitous decline over the last three months. The upper line shows the level

of jobless claims. Jobless claims are the weekly filings for unemployment insurance at the state level. When the economy is weakening, and layoffs are increasing, there is an increase in jobless claims as in the period of late 2001 when jobless claims reached 515,000. At the same time, in late 2001, non-farm payroll employment actually declined by 330,000 jobs as the economy was experiencing a recession. Recently, jobless claims have remained around the 300,000 level which indicates that non-farm payrolls should be growing in the 100,000 to 150,000 range each month. But last month payroll employment actually fell by 4,000. Something is not adding up here.

Graph 2. Initial Claims for Unemployment Insurance and Non-Farm Payroll Employment, Source: Bloomberg



With the employment statistics starting to show weakness, one of the main supports to the economy could be faltering. That leads us to become less optimistic on our outlook for the stock market. A weak dollar and strong manufacturing sector cannot offset a despondent domestic consumer. If the economy weakens more, it will put a damper on the current exuberance in the stock market.

Given our cautious outlook, here is how our various strategies survived the financial market turbulence of the third quarter:

Blue Chip Strategy: Our Blue Chip Strategy gained 4.06% in the third quarter versus a 2.02% gain for the S&P 500 Index. For the first three quarters of 2007 the Blue Chips gained 12.98% versus 9.05% for the S&P 500. The quarterly gain masks the volatility experienced during the last ninety days. From a peak of 14,000 on the Dow in early July, the market declined approximately 10% to a low of 12,517 on August 16th before rallying to new highs yesterday. The interest rate cut by the Federal Reserve provided the impetus for the rally since September 18th. The Blue Chips of the Dow Jones Industrials have outperformed other market sectors this year due to their perceived safety and their exposure to foreign markets. Proc-

tor and Gamble led the gains last quarter, up 15.57%. Home Depot was the weakest performer, falling 17.01%. Home Depot was hurt by the weakness in the housing sector and because they had to accept a lower price for their supply operation that they put up for sale. Citigroup was also weak, declining 7.99%, as credit market woes, subprime mortgage losses, and leverage buyout loan losses hurt their results. The technology stocks of the portfolio performed well as IBM, Hewlett Packard, and Intel enjoyed nice gains. At the close of the quarter, General Motors announced that they had reached an agreement with the United Auto Workers to offload their healthcare liabilities to a new trust controlled by the union. This agreement will allow GM to be much more competitive with foreign auto manufacturers that do not have the same healthcare costs. We think the blue chips should continue to outperform other sectors in the current market environment that prefers size, stability, and exposure to foreign consumers.

Small Cap Value Strategy: The Small Cap Value portfolio fell 7.70% in the third quarter versus a loss of 3.09% for the Russell 2000 Index. Year-to-date, the Small Cap strategy is up 15.01% versus a gain of 3.16% for the Russell 2000. We were not immune to the credit crunch as our position in American Home Mortgage that we purchased in April fell dramatically. We sold the position prior to the company's filing of bankruptcy in July after they could not meet margin calls. We invested in American Home Mortgage because over 95% of their portfolio holdings were AAA rated and they had low exposure to subprime mortgages. They even declared their dividend in April for payment in July, indicating that they were comfortable making the distribution. However, after the credit crunch hit, lenders asked for more collateral against credit facilities and the value of American Home Mortgage's assets fell in market value, so they could not meet the requests for more collateral. It was the proverbial "run on the bank". We knew there was financing risk with the position but we did not expect credit market conditions to deteriorate so rapidly. We endured a decline of 36% in the value of our position in Winn Dixie, who was one of our best performers in the second quarter. Winn Dixie was cautious in their outlook when they reported second quarter earnings, disappointing investors. They are in the early stages of their program to remodel old stores and are in good shape financially. We enjoyed a nice 60% gain in our Genco Shipping position during the quarter as the bulk commodity shipper announced the purchase of more vessels and new contracts at higher daily shipping rates. Markwest Hydrocarbon bounced back late in the quarter after they announced they were being acquired by Markwest Energy Partners for \$61 per share in cash and stock. The combined entity will be able to grow faster than Markwest Energy could on its own because the incentive distribution cash flows that Markwest Hydrocarbons received will be eliminated. We are still looking to add positions with high dividend yields to the portfolio.

Convertible Securities/High Yield Strategy: Our high yield convertibles strategy declined 5.67% in the third quarter versus a gain of 0.88% for the Merrill Convertible Index and a gain of 0.35% for the Merrill High Yield Index. For the first three quarters of the year, our portfo-

lio is up 2.40% versus a 7.44% increase for the Merrill Convertible Index and a gain of 3.35% for the High Yield Index. Taxable accounts in the strategy that hold publicly traded master limited partnerships in the strategy were hurt by the 12.5% decline in the MLP sector during the quarter. Our best performers for the quarter were Fairfax Financial convertible bonds that gained 18.10% and Gateway convertible bonds that rose 11.63%. The weakest performers were the MLPs and our Beazer Homes convertible bond that declined 16.83%. We added three new convertible bond positions to the strategy in the third quarter, including the Beazer Homes bond. Subsequent to the credit crunch, yields on below investment grade bonds rose considerably. Prior to June, we had difficulty finding bonds that yielded over 7.0%. After the bond market turbulence, we were able to purchase bonds yielding 9.0%. Trex Corp is a company that produces synthetic deck and fencing material. They are suffering from the housing sector slowdown but we own the bond with a 9% yield so we can afford to wait for a turnaround. We also purchased a convertible bond issued by Franklin Bank Corporation, a savings and loan headquartered in Texas. The company is transitioning from the old S & L model to a commercial bank. These bonds also yield approximately 9% to a put date in 2012. Our Sallie Mae convertible bond was called away from us in July after they announced a deal to be taken private in a leveraged buyout. (That deal is currently being renegotiated due to the change in financing conditions in the leveraged loan market.) We are pleased with the opportunity to pick up new purchases at better yields during the quarter. Investors are being compensated for taking on credit risk now as opposed to the conditions in the second quarter when risk premiums were too low. We expect the MLPs to stabilize as their yields are very attractive now and we anticipate impressive increases in their distributions over the next two years.

Intermediate Bonds: Our Intermediate Bond Portfolio rose 1.95% in the third quarter versus a 2.98% increase in the Citigroup 1-10 Year Government/Corporate Index. Year-to-date the Intermediate Bond Portfolio is up 2.67% versus 4.41% for the index. We did not have enough high quality bonds with long maturities in the strategy to benefit from the flight to quality that occurred during the bond market turmoil. The Intermediate Tax Exempt Bond Portfolio gained 1.89% in the third quarter versus 2.55% for the Merrill Lynch 3-7 Year Insured Muni Bond Index. We were able to purchase some very attractive yields over 4.0% in tax exempt bonds during the bond market rout as investors fled any kind of credit risk for the safety of Treasuries. We are concerned about the weakness of the dollar and the potential for inflation to pick up, but we think the prolonged weakness in the economy due to the housing sector will lead to more interest rate cuts by the Fed.

The financial markets should benefit from a friendly Federal Reserve in the fourth quarter. Let's hope that policy makers realize they will hurt the economy by pursuing punitive measures against illegal immigrants that are working and paying taxes. There has to be a better solution.

