

April 2, 2007

2007 First Quarter Review

For well over a year now, we have been writing about the possibility for trouble from the bursting real estate bubble and the danger of a spillover effect on the rest of the economy. It's no longer our little secret. Although it's now all the financial press seems to talk or write about, troubles in real estate shouldn't surprise you if you've been reading these letters. To recapitulate, the Fed panicked when tech stocks crashed in 2000 and the terrorist attacks came in 2001. The Federal Funds rate was cut to 1%, which fueled a real estate boom that became a bubble. Now the proverbial chickens are pecking at the door to come home. (Today, New Century, a sub-prime mortgage lender, filed for bankruptcy. The stock has dropped from 40 to 1 since November.) As recently as mid-February as the market climbed, there was still talk of a "Goldilocks" economy with just the right balance of factors to sustain the optimism of stock market investors. We worried about the complacency of investors, the lack of a "risk premium" for mortgage-backed securities, the leveraged nature of some institutions to mortgage risk, and about the Fed "tapping the brakes" until somebody went through the windshield. We warned of a return of volatility while complacency ruled. Now it seems that everyone woke up at once to the danger of the situation posed by adjustable mortgages being reset higher, housing prices slipping, rates rising and foreclosures increasing. I hope you don't know what a "no-doc, interest-only, adjustable-rate mortgage with a silent second" is. Suffice it to say that it is no longer the preferred type of mortgage. Unfortunately for some, we have the banking industry tightening standards just when many need to avoid foreclosure. The situation has the makings of a classic liquidity crunch, when the amount of money available decreases and prices suffer accordingly.

Those of us who have been around for awhile have seen this kind of thing before. You may remember the Savings and Loan crisis and the "Keating Five." History repeats itself, but never verbatim. Now we have investors holding Collateralized Debt Obligations (CDO's) and Commercial Mortgage-Backed Securities (CMBS's) (and other securities with investment-grade "tranches" galore) who have assumed the risk that the Savings and Loan industry took in its era of excess. The spillover effect on the rest of the economy is starting to become apparent, and the worst may not yet be over.

The normal reaction to such developments would be weakness first in the stocks of homebuilders (check), then financial stocks (check), then retail/consumer and finally industrial stocks as the effects ripple through the economy. When recovery occurs, the stock prices often begin rebounding in the same order.

The logical conclusion to all this nasty news is that, when things look bad enough, the Federal Reserve Board will act in its capacity as steward of the American Economy and lower interest rates. While it may not be enough to entirely correct the situation, it

may give stocks a good boost, especially those in the financial industries. That is the silver lining in the cloud that now hangs over us.

For all the gyrations during the quarter, the Dow Jones Industrials declined almost 1%. Gains in the S&P and Nasdaq were close to zero. We took some profits on our holdings during the quarter as the Dow reached its peak on February 20th and subsequently dropped 6.7% to March 3rd. After that drop, we are beginning to see stocks that are cheap enough to interest us and will likely continue to add to stocks if further weakness occurs. We tend to be contrarian investors and we love to buy bargains when others are frightened into selling cheaply. This requires two things, capital and discipline. We have maintained the capital in preparation for this, and we intend to employ the discipline should things look worse before they get better. However, if stock prices run up quickly, we may keep our powder dry and wait for better opportunities.

To avoid repeating too much from previous letters, we would simply reiterate that returns from good investments are often “lumpy,” not the comfortably gently upward slope that we might prefer, that opportunity often looks scary and the best time to invest is often the hardest time to do so. Most of the investments we have made have been good ones and, over time, they have proven themselves worthy of the capital that we committed to them. Just recently, Kohlberg Kravis & Roberts (KKR) has offered to buy our Dollar General stock for \$22 per share, roughly a 60% premium over our purchase price last summer. With the consummation of the deal later in the third quarter, we will just go long-term on that gain and qualify for the lower tax rate. We expect there are other similarly good values among our holdings and more to be found, if we are willing to be opportunistic.

Enclosed you will find your quarterly reports and statements. As always, we welcome your questions, comments, and suggestions. If you need any information from year-end in order to file your taxes, just call me or Alice Marie and we will get the information to you quickly by fax or e-mail.

As is our annual regulatory duty, we hereby offer to send our “Form ADV Part II” to you upon request. It is also our policy that we never divulge any information about you or your account to anyone without your consent.

I thank you for the opportunity to work with you on your investments and I look forward to continuing our search for value.

Sincerely,

Claude R. Carmichael CFA