INVESTMENT LETTER

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YEAR-END MUSINGS

The time of year has arrived for all investors to stop and take stock of what has transpired over the past year. Many things should be considered, both the good that has happened and what might be changed to make us better off when the next year-end rolls around. We will try to be brief and cover only key items as simply as possible.

Item #1 — After several years of lack-luster performance, stocks finally paid off for the patient investor. Excellent underlying financials for major public companies, low inflation and interest rates, and continuing economic strength have all warranted higher share prices for quite some time. Only the reasons why it took so long remain a mystery to those "investors" who chose—rightly in our opinion—to refrain from joining the increasingly crowded "traders" arena when things looked a little weary along the way.

As always, at year-end we calculate and compare total returns for many different investment sectors. We try to make it easy to understand by showing how well an investor in each sector would have fared if he or she had invested $10,000 in each sector on the first day of the year and kept that investment for the full 365 days. Next month we will share our findings on how stock investors fared on a total return basis in 2006 and for the past five years.

Preliminarily, it appears that large company stocks, like those used to calculate the popular and widely followed Dow Jones Industrial Average, out-performed most other major categories for the year, coming in at a nice 19% for 2006. And, the good news is that based on our own model's "warranted" value calculations, share prices for these large companies continue to lag the financial successes of those very same companies. In other words, the prices for most major U.S. companies are still well below levels justified by profits and return rates on capital.

Item #2 — We have long feared, and said so in print, that it must be more than coincidence that the long period of lagging stock prices correlated so closely with the ascent of hedge funds and their trading ilk. That these two major factors just so happen to have occurred over the same time period just does not cut it with us as a plausible explanation. Wall Street's love affair with massive derivative usage—ostensibly to manage "risk" for large portfolio managers—also took place during the same period. The bad news is that much of this seems, as we alleged many times, to have "sucked the air" out of share prices along the way.

Now, however, the re-emergence of rising share prices may be marking a coming end to that questionable era. Former advantages to traders that allowed so many to make quick, high profits at the expense of long-term investors appears to be slowly disappearing. Blaming such trading for the long lull in stock prices during this period of disconnect with corporate successes is never going to be something that a person or regulatory body can prove absolutely. The statistics are simply too hard to tabulate for this worldwide phenomenon.

Nonetheless, there is considerable anecdotal evidence to substantiate one's intuitive leanings in that direction. Technically, and at least to intent, some of these activities may have been in violation of the securities laws of 1933, 1934 and 1940. These regulations were, after all, passed into law because of the abuses of traders at that time, in which "boiler room" type practices exacted a heavy toll on the ordinary investing public. Much has changed electronically since those days. However, in our view, not much has changed as to the negative impact that an insider with a lot of money can have on publicly traded shares of major companies. Let's hope the future will return risk management practices to legitimate investment purposes.

Item #3 — Last month's Investment Letter dealt with investor worries regarding the outcome of the just completed interim national election. Our conclusion was that stock prices are about as good a barometer as one can find as to whether investors have reasons to fear the election's result. Rising stock prices suggests to us that the impact is likely to be modest for many reasons we will discuss some other day.

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For now, though, there is one aspect that we think should be mentioned, even though it is an enormously complicated one. That aspect is the renewed presence of a possible conflict between the two principal economic theories that have fought for supremacy over the past several decades—"Keynesianism" versus what we will politely refer to as the "incentivist" theory of economics.

Lord Keynes, a British economist who advised then-President Roosevelt during the Great Depression, formulated a theory in which government played a critical economic role through taxation and spending. That concept, though now widely discarded, still has adherents who cling to some of the vestiges of his failed theory. Since then, most economists in and out of academia, have become followers and adherents of the "incentivist" theory of free market capitalism.

The reason for bringing this issue up now is that there are occasional references in the media and elsewhere to suggest that some of the older policy-makers returning to high places in Washington may be having occasional trouble breaking with old, Keynesian habits. The reasons for this are never spelled out in those terms, but it appears that for some of them their motives are clearly more political than economic.

We want to make sure our readers understand that if real, this concern is long term in nature. The economic successes over the past two decades are now almost indisputable around the world. And, those successes are now known to be attributable to U.S. cy-makers having adopted the in- ist theory of economics.

Laws were passed that demonstrably improved mankind economically, notwithstanding never-ending debates along the way regarding the "haves" versus the "have-nots." As it turns out, almost all classes of citizens are better off today than they were when government spending programs were on the rise as a percentage of Gross Domestic Product. Since tax rate relief took place and spending plateaued as a percentage of the total federal budget, the Economy has never really faltered for any meaningful time period.

The concern now is that if some political and monetary leaders start waffling on the merits of an advancing economy by tampering with the policy reasons for its success, investors will certainly need to renew their interest in a political process that forgets how the economic largess was produced in the first place. At this time, we have considerable faith that the stock market's vote of confidence is correct, that is, it is highly unlikely that a reversal of economic policies has even a remote chance anytime ahead, regardless of which political party holds sway.

Item #4 — Like many, from time to time we have some worries about the way developing super-countries like China think about free markets. From our own reading of things, at this stage in that country's history, positives far outweigh negatives, despite grousings from some of our own politicos. Perhaps the short answer is that free markets, once unleashed from the tyranny of a controlled system, have a habit of prevailing in the end. Success has a funny way of persuading even the staunchest "top-downers" that the interests of a society's people are always best served when petitive economic forces are left alone to work. Governments have plenty to do in those areas where government alone must control things. So, without over-analyzing China we subscribe to the view of one famous theologian of our day who told Chinese leaders recently that to be like America, as they claim they want to be economically, requires three things: free markets, freedom of religion, and free speech—two of which they do not yet possess. As he put it, a three-legged stool cannot stand on just one leg. Nicely said, don't you think?

CONCLUSION: The coming of age of many backward civilizations causes worldwide demands for goods and services to transcend the economies of the super powers alone. This, plus the existence of decent fiscal and monetary policies in a large segment of a fast-shrinking world, suggests that economic advances will continue in the future. This is especially so for Americans who still reside at the top of the pyramid, mainly because our stool has three legs and it seems likely we'll keep all three for a long while ahead.

Happy New Year!

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