Ponderosa Investment Group LLC
INVESTMENT LETTER

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Quarterly Investment Commentary

During times where economic indicators are confusing, investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times.

There are no asset classes priced at bargain levels. But on a relative level there is one area I continue to be excited about: large-cap domestic stocks.

The lack of bargains on an absolute basis does not mean that markets are overpriced. Today, many things are fairly valued. It's not exciting but it doesn't suggest a defensive portfolio posture.

The Investment Letter is mailed quarterly to my clients and friends to share some of my more interesting views.

After an uninspired first quarter, stocks around the world surged in the second quarter. Domestically, bigger was better, with larger companies delivering the highest returns, followed by mid-caps and then small-caps. It was also a good quarter for growth stocks. Fueled by the second quarter's returns, growth indexes have now out-returned value indexes for the year to date in all market-cap segments. International stocks had another strong quarter and out-returned the U.S. stock market once again. REITs suffered a sharp correction, losing 9% during the quarter and have now experienced an 18% decline since peaking in early February.

2007 Index Performance	2nd Qtr.	YTD
Citigroup 3 Month T-bill Index	1.24%	2.49%
Lehman US Aggregate Bond Index	-0.52%	0.98%
M.L. US High Yield Master II Index	0.32%	3.06%
S&P 500 Index	6.28%	6.96%
Russell 2000 Index	4.42%	6.45%
MSCI EAFE N$ Index	6.40%	10.74%

Ponderosa's investment models continue to perform well. So far this year they have outperformed their policy benchmarks. The alternative\absolute retuning asset class has contributed the most to this out performance.

Investing Without Bargains

In every economic cycle there are points where the indicators are particularly confusing. During these times investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times as investors wavered between fears of economic weakness (driven by the housing market) and strength (driven by the buyout boom and a strong global economy).

I've never believed that I could add value using an investment strategy that relied on accurate forecasts of the economy over the shorter term. Instead I focus on identifying tactical opportunities in which asset classes are fundamentally mis-valued. When I find them, in most cases it means a superior return opportunity. At the same time it means I believe I have a significant margin of safety to protect the portfolios from the many risks that are always present. Even when there are no bargains, I can generally assess valuations in the various

asset classes so I can form an opinion about the degree to which there is (or isn't) a margin of safety. Couple this with scenario analysis, which allows me to stress-test the portfolios for a variety of potential economic and market environments, this is how I make prudent investment decisions in an uncertain world.

At an absolute level, there are no asset classes priced at levels that give me confidence they will likely capture big returns over a several-year time horizon. On a relative level there is one main area I continue to be excited about: large cap domestic stocks.

Large-Cap Domestic Stocks: From November 1999 through February of this year, large-caps (S&P 500) had a total cumulative return of only 9.6% (1.5% annualized) compared to 72.7% (9% annualized) for small-cap stocks (Russell 2000 Index). This sizable performance discrepancy leaves large-cap stocks bargain-priced compared to stocks of smaller companies. Moreover, stocks of larger companies tend to do better when the dollar is weak (their foreign earnings are worth more converted back to dollars and U.S. exports become more competitive), which is partly why mega-cap stocks are now experiencing stronger earnings growth than smaller companies. They also tend to perform much better than small-caps late in the economic cycle. We may or may not be late in this cycle but we are clearly past the early stage.

A reasonable question to ask is whether large-cap stocks are cheap on an absolute basis, or only a less-pricey segment of an overall market that is expensive. My short answer is that I believe domestic large-caps are reasonably valued and therefore attractive, though not so attractive that I would pound the table over them.

There is risk to my view. We've just experienced the greatest earnings boom since World War II, thanks partly to profit margins hitting a 40-year high. So the question is: While the stock market looks reasonably valued or even undervalued based on earnings, if profit margins were to move back to "normal" levels wouldn't the overall stock market then be overvalued? There are really two questions here:

1) Are profit margins likely to decline significantly?
2) If they do, will stocks be overvalued without a price decline?

It does appear that profit margins are likely to decline in coming years:

- Labor costs are a big part of the equation. Historically, increasing labor costs have been the biggest driver of declining profit margins. The massive growth in the global labor market from China, Eastern Europe, and other parts of the developing world, along with technology-based productivity increases have made it difficult for labor to grab as big a piece of the economic pie. However, labor's lack of leverage may soon stop deteriorating and gradually reverse, increasing labor costs are starting to put some pressure on margins. But a big jump in labor costs doesn't seem likely in the foreseeable future.

- Interest expense is beginning to increase due to new borrowing and rising interest rates.

So, some margin pressure seems likely as the drivers of widening margins lose their momentum. However, it is not clear that margins will suffer a huge decline. Top-line growth has been healthy, and given a very strong global economy, revenue growth could stay reasonably strong. And though productivity is slowing and labor costs may not be as much of a positive, there is still an abundant supply of labor around the world and will be for years to come. China still has a long way to go in its transformation to an industrial economy. So, while I expect profit margins to decline and earnings growth to slow, I'm not assuming the slowdown will be alarming unless there is a recession.

What if margins do suffer a large decline? If it is gradual, the stock market may not be hurt too badly. This is because stock valuations appear to offer some margin of safety. Plugging in much lower "trend" earnings (that take out the huge surge of the last few years) into the primary valuation model, stocks appear to be in a fair-value range given current interest-rate levels. Most other valuation metrics I look at are also fairly encouraging. However, if there is a sharp and sudden earnings decline, as would be likely in a recession, stocks would almost certainly be hit. But, as I showed in detail last quarter, if I look out over five years, current valuations seem to suggest that it is reasonably likely that stocks will do better than bonds, even in a fairly bearish earnings environment. This isn't all that surprising—since 1960, profits have had nine down cycles and stocks rose in five of them as P/E ratios rose. In my view, a sharp decline in earnings is possible but not the most likely scenario.

Addressing the general question of the outlook for stocks, there are several other bullish factors. One is the huge volume of money raised by private leveraged buy-out funds. According to investment firm Bridgewater, there is $300 billion of capital committed to these funds that is yet to be deployed. With the typical levels of leverage (i.e., debt) employed by buyout funds, this could result in almost $3 trillion of buying power. Over the last few years buyouts as well as corporate share repurchases have removed a sizable amount of stock from the stock market—about $1 trillion (net of new and secondary issues) since mid-2004. Though some of that stock may come back into the market as private equity firms exit their investments by taking their privatized holdings public, this trend of sizable amounts of stock disappearing through privatization seems likely to continue for a while and is a bullish factor.

A second factor that is hard to quantify is the growth in sovereign wealth funds. These are state-run investment funds that invest a portion of a country's currency reserves. Those countries with excess reserves to invest in this way include China and other developing countries with positive trade balances, as well as many of the oil exporting countries. According to a recent article in *Barron's*, Stephen Jen of Morgan Stanley estimates that these funds may have as much as $2.5 trillion and are growing rapidly. Their objective is generally to capture higher returns than those offered by government securities (such as U.S. Treasury bonds), which means investing in areas like private and public equities and real estate. China's recent $3 billion investment in the private equity firm Blackstone Group is an example of this.

Perhaps the biggest risk to longer-term stock returns is inflation and interest rates. The rapid growth in the developing world has caused demand for basic commodities to spike in a big way and is one source of potential inflation. At some point supply is likely to catch up with demand but that point may still be years off. However, there is a growing consensus among some of the sharpest fixed-income managers that inflation from a variety of sources is working its way back into the system and that it is likely to move higher in the next cycle (though no one I know of is predicting double-digit 1970s-style inflation).

We haven't seen government bond yields of 6% since they were briefly there in the late 1990s. If we get yields that high or higher in a few years and they stick for a while, investors will require higher expected returns from stocks to justify owning them. Higher returns in that case would require lower prices for stocks relative to their earnings. If we experience an extended period of rising rates it will be an environment that investors haven't experienced since before the early 1980s, when interest rates peaked and began a 20-plus year downward trend. At this point, given the likely continued growth in the global labor force and the potential for productivity strength, a sizable and long sustained rise in rates doesn't seem likely.

Getting back to the question of large-cap stocks, what is the bottom line? Based on analysis, large-cap stocks are a compelling oppor-

tunity *relative* to stocks of smaller companies (small caps). Thus, relative to the benchmarks I'm underweight small-caps and overweight large-caps.

Over the shorter-term, as investors continue to try to read the economic tea leaves in an environment with various cross currents and stresses, I wouldn't be surprised to see some news—economic, financial, geopolitical, a hedge fund or derivative-related blow-up—over the next year that spooks investors and triggers a quick stock market correction. A 10% decline would not be surprising given the performance run since February of 2003 (the S&P 500 has almost doubled). This isn't a prediction but I wouldn't be surprised. If it does happen, I think the downturn is likely to be a short-lived correction rather than the start of a bear market, unless we are heading to a recession, which is possible but seems unlikely given current global economic strength.
As always, I will continue to challenge the assumptions that underlie my view, consider new information as it becomes available, and stay intellectually honest in making well-reasoned investment decisions for my clients. I appreciate your confidence and trust.

Best Regards,

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