Ponderosa Investment Group LLC
INVESTMENT LETTER

Fourth Quarter 2006 • v3

Quarterly Investment Commentary

Summary:
It was an eventful year in 2006, with energy prices, the housing market, and Fed policy all impacting the investment landscape. Early in the year investors feared rising rates, but once the Fed ended its string of rate hikes the market climbed steadily higher.

Most asset classes had good or even great returns for the year, with foreign stocks doing especially well, and domestic equities returning in the mid to high teens.

Despite rising stock prices, equity valuations remain attractive thanks to strong earnings, suggesting either that stocks are undervalued or that the market is discounting a material slowdown in the economy.

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

Oh what a year!! Most asset classes performed very well for the year, returning almost twice what was forecasted by the prognosticators at the beginning of the year. Smaller-caps once again lead large-caps for the year, continuing their run of outperformance that began in 1999-2000. The small-cap Russell 2000 index was up 18.4%, while the large-cap S&P 500 was up 15.8%. The mid-caps underperformed both small and large-caps for the year, returning only 10.3%. The value indexes vastly outperformed their growth counterparts across all market caps. As a group, the broad universe of diversified active equity fund managers underperformed their benchmarks, with value managers having a particularly tough year respective to their indexes. Despite a multi-year run of great returns and uncompelling valuations, REITs surged by 35.1% in 2006 as investors continued to pile into the asset class. While a case might be made that REITs aren't severely overvalued, it is hard to imagine them performing as well as the broader equity market in coming years given current valuation levels.

2006 Index Performance

Index's	4th Qtr.	2006
Citigroup 3 Month T-bill Index	1.29%	4.07%
Lehman Aggregate Bond Index	1.11%	4.84%
CSFB High Yield Index	4.45%	11.93%
S&P 500 Index	6.70%	15.80%
Russell 2000 Index	8.90%	18.37%
MSCI EAFE N$ Index	10.35%	26.34%

On the fixed-income side, bonds performed much better than most anyone had expected. Domestic high-quality, intermediate-term bonds had a respectable year, with the Lehman Aggregate index gaining 4.8%. Foreign bonds were aided by a currency tailwind, lifting developed markets foreign bonds to a 6.1% gain.

A broad observation about returns in 2006 is that riskier asset classes generally did best. With a gain of almost 27%, foreign stocks did very well, but the riskier emerging-markets asset class gained close to 30%. Back home, the high-yield bond benchmark

was up about 11.9%, while the riskiest bonds in the high-yield universe—those rated CCC and below—gained about 19%.

Investors' willingness to take on risk implies a lower risk premium. Interestingly, though, valuations for the S&P 500 reflect a different story: My analysis suggests this index's valuation is either too low or investors are pricing in an economic slowdown, which wouldn't be good for risky assets. Meanwhile, real interest rates are very low, which usually means bond investors are worried about recession (suggesting risk aversion). I don't know who will turn out to be right. Valuation analysis is complicated by the participation of foreign investors and hedge funds, which have their own agendas that may have little or nothing to do with the aforementioned observations—for example, interest rates might not be low because of recession fears, but rather because foreign investors currently prefer our bonds to their own.

Investment Review

Recapping 2006, it was an eventful and at times tumultuous year. The difficulties in Iraq and the related shift in power in Washington D.C. were two big stories, but not as interesting from an investment standpoint as the stories on oil prices, the housing market, and Fed policy.

After beginning the year around $60 per barrel, oil peaked near $80 per barrel and fostered the belief among some industry watchers that higher oil prices would continue indefinitely (pundits were talking about $100 per barrel oil). Many of the managers and strategists I follow believed that oil prices would come down, which turned out to be true, and oil ended the year at roughly the same place at which it began.

The big question on the housing market was when or if the housing bubble would burst, and what the fallout would be. While some regions were hit hard, a broader analysis suggested that while the risk of a housing decline was very high, the magnitude and spill-over into the broader economy was not sufficiently high to warrant a defensively oriented move within the portfolios. I'm glad I stuck to my guns on that, since a defensive posture would have caused the portfolio's to miss out on a portion of the very good stock market returns for the year. As of this writing, the housing market has already cooled off some, but it's still too soon to say how much further it might have to go.

Fed policy was a big driver of the markets in 2006. Early in the year, investors were growing concerned that the Fed might overshoot interest rates and cause a recession. By summer, the Fed had hiked rates by another 125 basis points, and stocks suffered. Once the Fed announced that it was on hold for future hikes, the market spent the rest of the year bouncing higher. Today, there is growing talk of the possibility of a recession that would lead the Fed to begin cutting rates again. This illustrates the fickle nature of investors' short-term sentiment. In less than six months, the market went from concerns about rising rates damaging the economy, to relief that the rate hikes were over, to fears of a cyclical recession (which would lead to falling rates). In the real world, underlying fundamentals seldom change that quickly. I think the message here is that objective investment analysis that focuses on the longer-term is a definite advantage. Being in "reactive mode" is an almost sure-fire way to get whipsawed, since the market reflects investors' sentiments instantaneously. But short-term investor sentiment rarely impacts long-term fundamentals.

Equity Market Outlook

The S&P 500 returned almost twice what most pundits had predicted for the calendar year. With a 15.8% return for 2006, stocks may "seem" like they should be getting expensive. In truth, though, the valuation picture has actually changed very little. This is because company earnings have gone up along with stock prices, leaving the relationship between prices and earnings at about the same place. At year-end 2006, the valuation model showed the S&P 500 as being approximately 18% undervalued (the model showed the market at a 15% discount to fair value at this time last year). It's worth remembering that the new highs reached by some indexes are only now eclipsing levels that were first seen nearly seven years ago.

Where does this all leave us? Attractive valuations tell us the market is either cheap—meaning returns going forward are likely to be better than average—or that the market is discounting a meaningful decline in the earnings fundamentals. I've seen signs of slowing earnings growth and a deceleration in the economy. Part of this is normal cyclical behavior, and some may be in response to the slowdown in the housing market, but in either case it is clear that we're coming off of a spectacular period of earnings growth, and things are likely to cool off. But at current valuation levels a pretty big margin of safety is already baked into the market.

The overall equity exposure in my models remains overweighed relative to their neutral weights. Throughout the year there have been some changes, for example, the extended period of small-cap outperformance created a valuation disparity relative to large-caps, which caused me to shift some money from small-caps to large-caps late this year. Looking overseas, valuations of foreign stocks are roughly in line with their historical average relative to the U.S., however the portfolios are still slightly over weighted to foreign stocks, given the prospects of better relative performance coming from stocks versus bonds.

Bonds

With the Lehman Aggregate Bond Index yielding better than 5%, intermediate-term investment-grade bonds are likely to generate returns in the 4% to 6% range on average over the next five years. The beauty of bonds is that their returns are based on straightforward math. For example, I know that if interest rates go from 5% to 3%, a bond yielding 5% with a 4.3 year duration will return 5.7% annualized over a five-year period. Individual calendar years can be higher or lower, depending on the pattern and timing of rate changes, but on average I expect bond returns going forward to be generally in line with their long-term historical average.

Alternative Assets

This asset class performed well for the 4th quarter, returning more than 2.0%. This asset class is new to all the portfolios for 2006 and is focused on providing absolute returns throughout the calendar years regardless of the stock or bond markets. Had this asset class been in the portfolios for the entire calendar year, it would have returned almost 9%. As most of you are aware, for years I've felt this asset class was prudent to add to portfolios due to its favorable risk and returns characteristics. Now that I'm on my own, I'm able to add this asset class, improving the risk reward ratio for portfolios that I manage.

Performance Discussion

As always, I'm in regular contact with all of the managers I use in the portfolios, and I'm careful to understand what is driving the funds performance. If any developments, performance or otherwise, impact my original

basis for confidence in the manager, I will act accordingly. I remain highly confident in the managers I use. However it is not realistic to expect a manager to beat a benchmark each and every calendar year. In order to outperform in the long term, a manager has to have the conviction to look different from the benchmark, and this will inevitably result in periods of under and over performance. I'm confident that over longer time periods the managers, and models, on the whole will beat their benchmarks.

In Summary

At current equity valuation levels, I think return prospects for my models over the next five years are reasonably good right now under the scenarios I consider most likely—in a range from mid single-digits for my most conservative model to perhaps low double digits for my most aggressive model. I can't predict the timing of those returns, except that it is highly unlikely that they will be smooth from year to year. I'm confident, however, that by remaining aware of overall portfolio-level risk and setting allocations accordingly, taking tactical allocations only when highly compelling opportunities are presented, and using managers I believe to be highly skilled, I can earn above-average long-term returns while keeping the shorter-term downside risk within the loss thresholds.

Company Update

As Ponderosa Investment Group, LLC approaches completing its first full year as an investment management firm, I'm grateful to my clients and friends who have supported and helped me grow this firm to a very respectable level for my first year. At this time, I'm accepting new clients on a referral-basis, with a $500,000 initial minimum to invest.

With the New Year upon us, I wish everyone a blessed 2007. As always, I appreciate your confidence and trust.

Best Regards,

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