



Steinberg Asset Management, LLC

April 2006

## First Quarter 2006 Commentary and Outlook

The S&P 500 finished its best first quarter since 1999 with a gain of 3.7%. Small cap stocks were the star performers, outpacing the S&P 500 by 9.8% with telecom services, metals, and technology leading the way.

### **Concerns persist**

There continues to be no shortage of things to worry about for investors, including, but not limited to, further Fed tightening, a wavering housing market, the end-of-the-yen carry trade, twin deficits, confrontation with Iraq, an avian flu pandemic and growing protectionist sentiment. However, absent a major shock to the financial markets due to any of the aforementioned, further market gains appear most likely dependent upon where and when the Fed stops its tightening campaign and the subsequent effects its actions have upon liquidity.

### **Mixed pressures on interest rates**

At the moment, the market appears to be holding the view that a combination of higher energy prices, a softening in the housing market and the lagged effects of the Fed tightening campaign will conspire to slow economic activity, permitting a halt to rising interest rates. This in turn could end the compression of valuation multiples, which has restrained the market in the face of healthy earnings growth. However, trends in the labor market – in particular the decline in unemployment and acceleration in wages – may have to weaken to induce the Fed to embrace the notion that growth is indeed moderating and further tightening is unnecessary. Moreover, if the recent rise in consumer confidence (now at the highest level in almost four years) persists, the Fed may be moved to raise rates further than generally anticipated – a move not likely to be warmly received by financial markets.

### **Energy and health care remain a focus**

For us, and your portfolio, we remain focused on identifying equities of well-financed businesses that are in a position to achieve superior long-term rates of return with limited risk to capital. An example of this is our current view on the energy sector, where we have no interest in speculating on the short-term gyrations of the underlying commodities (oil and/or natural gas). Rather, we are making long-term investments in companies that should prosper in the years ahead, independent of commodity price forecasts. We do, however, recognize that these holdings are likely to experience extreme volatility from time to time. In January, the S&P Energy Index rose better than 13% and then declined 8% in February. We understand from time to time violent corrections may occur. We view these temporary downdrafts as fluctuations in a long-term rising trend for the respective equities.

In the energy sector, we are attracted to prospects in heavy oil, where we believe the price differential between lower-grade and higher-grade crudes continues to favor the former, such that the differential is likely to narrow in the years ahead and this should translate into materially higher asset value for the underlying equity. In addition, we have recently started to build positions in several energy service companies where the

demand for their technical expertise places them in a position to demonstrate rapid revenue growth and dramatic earnings gains in the years ahead. We are particularly interested in companies positioned to benefit from the Russian energy market where convergence of national interests and economic opportunity may create significant new sources of demand for well positioned companies in the coming years.

We continue to search for and build positions in health care companies that appear capable of effectively addressing the challenges posed by an aging population in a fiscally constrained society. Companies that have technologies or products whose economic potential are not recognized by the market are of particular interest to us, as are those involved with lowering health care costs that should therefore benefit from efforts to overhaul the health care system.

On balance, we continue to believe that sound fundamental research coupled with a longer term focus will serve to produce superior long-term investment results.

Sincerely,

A handwritten signature in blue ink that reads "Michael". The signature is fluid and cursive, with a long, sweeping tail on the letter 'l'.

Michael A. Steinberg  
Managing Partner