Steinberg Asset Management, LLC

First Quarter 2007 Commentary and Outlook

Amid concerns over speculation in US real estate and Asian financial assets, global equity markets sustained a bumpy ride in the first quarter before finishing with low to moderate gains. Stock purchases by private equity groups and share repurchasing by corporations provided a counterbalance to market worries. The S&P 500 advanced 0.6% for the quarter. Small and mid-cap stocks fared better; the Russell 3000 Value Index returned 1.3%, the Russell Midcap Value Index rose 4.9% and the Russell 2000 Value Index returned 1.5%. Your portfolio performed well both in absolute and relative terms in this environment. Stock selection decisions in the consumer staples and industrials sectors and the underweighting of financials stocks contributed to outperformance of our benchmarks. Stock selections in the consumer discretionary sector detracted from relative returns.

Housing and Mortgage Weakness Send Ripples through Markets

For several years, the combination of easy money from mortgage lenders and the loose lending practices they followed has fueled demand and driven housing prices to levels unsupported by economic fundamentals of replacement cost or homeowner income. The practice has now come to a head at the low end of the credit scale where an estimated 20% of all mortgages were written in 2006 and where delinquencies for subprime mortgages (those issued to the least creditworthy) are running at more than 12%. Moreover, evidence suggests that problems with creditworthiness do not end at subprime but extend to the “Alt-A” segment, which accounted for about another 20% of all mortgages written in 2006.

The consequence of highly visible troubles affecting a relatively large proportion of homeowners will likely be new regulatory guidance, the first of which may be in place for the subprime market this summer. With general tightening of mortgage lending standards, housing demand is likely to contract meaningfully at the same time inventories are rising to historically high levels. With demand falling, perhaps sharply, and supply rising, prices may come under more downward pressure than historic experience has evidenced. This housing sector weakness is likely to create a drag on the general pace of economic activity, perhaps greater than current consensus.

Far-reaching Effects

While it is difficult to gauge with precision the impact housing will have on the economy, the following numbers provide a framework for thinking about the magnitude of burden the housing market will place on economic activity as the downturn unfolds in the months ahead.

Fallout will affect the economy both directly and indirectly. Residential investment (new homes built) accounted for 5.8% of GDP in 2006. Therefore, a conservatively estimated 10% decline in demand would directly impact GDP by about 0.6%. Mortgage industry executives recently estimated 60% of the subprime loans made in the past year would not qualify under the new guidelines. In addition, the indirect wealth effect may be most visibly seen in further reduction of Mortgage Equity Withdrawals, which are estimated to have contributed around 1.5% to fourth quarter 2006 GDP.

Additional Headwinds

Other elements of the economy also offer less-than-encouraging outlooks:

- Expenditures for capital equipment have not grown for a year and with profit growth decelerating, capex and employment are both likely to disappoint in coming quarters.
- Recent sharp increases in gasoline prices – up more than 20% in two months – show little prospect of reversal and represent another drag on consumer spending.
- Finally, the prospect of rating agencies downgrading Collateralized Debt Obligations (CDOs) is likely to unsettle both investor confidence and financial markets.

On balance, as we move toward the second half of 2007, risks to economic growth appear tilted to the downside. However, so long as liquidity remains ample the absence of extremely high valuations should help cushion fallout from earnings disappointments, particularly if inflation concerns recede and the Fed begins to lower interest rates.

Attractive Opportunities

Mindful of these challenges our economy and financial markets face, we are optimistic about the long-term investment prospects embedded in your portfolio. The companies you own are well financed and have differentiated positions, strong asset bases and able managements which should drive superior long-term growth and above average long-term returns.

We have recently identified several securities that appear to have extremely favorable risk-reward profiles, and we are prepared to expand or initiate your investment position as market conditions provide attractive opportunities. For example, we have begun to build a position in a company that we believe has a franchise-like financial information platform serving the professional/institutional market. This business has a seasoned, highly regarded management team, is well financed and appears positioned to demonstrate leveraged earnings gains in the years ahead even in periods of financial market turbulence.

Sincerely,

Michael

Michael A. Steinberg
Managing Partner