



Steinberg Asset Management, LLC

## Second Quarter 2006 Commentary and Outlook

The second quarter got off to a strong start with the market extending the robust gains of the first quarter. However, equity markets made an abrupt about-face when the Fed made it clear that interest rates would be on the rise again on inflationary fears—a development that took investors by surprise—resulting in a sharp decline in the market averages as investors reduced their preference for risk. For the quarter, the S&P 500 finished with a loss of 1.9%, while the Nasdaq was down 7.17%.

Perhaps more than any other factor, it's the actions of the Fed that will dictate how the financial markets will perform in the period ahead. So as long as inflation and economic growth appear to be on an acceptable path, members of the Federal Reserve Board and the financial markets should sleep better at night. A legitimate fear exists with respect to the Fed possibly overshooting monetary policy objectives. In fact, present numbers for the core Consumer Price Index linger dangerously above the Fed Chairman's stated "comfort zone" of 1% -- 2%. And in recent months, U.S. consumers and investors alike can't help but notice that everything from filling their car's tank to a new lease on an apartment has been rising. Whether Mr. Bernanke decides to tighten further will be based on many factors, some of which are discussed below.

So long as investors believe an end to the Fed induced rise in interest rates is not far away, our financial markets should behave reasonably well. However, news in the coming months of persisting inflationary pressure—suggesting that the inflation-wary Fed may feel compelled to extend its tight monetary policy longer than is generally anticipated—would not be well received by the financial markets. In this regard it is worth noting that underlying inflation, measured by the "core" CPI, has recently risen to an annual rate in excess of 3%. This rate of increase may accelerate in the months ahead, in part because apartment rents, a major component of the CPI, is increasing at a rapid rate. In addition, capacity utilization throughout the economy has risen to levels which have restored a measure of pricing power to both business and labor. The combination of these elements suggests the rising rate of inflation may persist longer than expected.

While the forces at work appear to be largely shorter term in nature and inflationary expectations look to be muted, the sixty four dollar question is: how will the Fed respond to the prevailing set of challenging economic circumstances? On one hand, the rate of inflation is already above the top of the Fed's comfort zone, and still accelerating. On the other hand, the economy has already begun to slow—particularly the housing market and consumer spending—under the weight of rising interest rates and higher oil prices.

With the speculative froth from excess global liquidity beginning to give way to rising interest rates around the world, the future path of financial markets will rely heavily on the judgments and actions of our monetary policy makers. If the right balance is struck between maintaining reasonable growth and containing inflation over the long-term, then our financial markets should respond well to receding interest rates and the economic prospects that tend to follow a mid-cycle slowdown.

For us and your portfolio, the market's volatility and uncertainty should continue to present excellent investment opportunities in well financed businesses that can produce superior long-term returns

Short-term results have been penalized by some of our natural gas related holdings, where growing inventories have depressed the commodity's near-term price and soured investment sentiment towards these energy related securities. We think it is important to recognize, however, that our investments in energy sectors are not based on commodity price speculation, but on price assumptions based on the commodities' marginal cost of production.

In the case of your exploration and production holdings, we have made the investments at prices equal to, or below, the net asset value of the companies based on the equilibrium price of the commodity (marginal cost of production). Therefore, we believe we have essentially purchased a free-call on the potential for large increases in asset value that may occur over the next few years as a consequence of the monetization of unrecognized value in acreage positions.

We will continue to build your portfolio employing this strategy of investing in well managed and soundly financed companies that own valuable assets that are accreting in value—selling at a discount. This gives us confidence that, independent of the short-term vicissitudes of the market your portfolio is well positioned to demonstrate attractive long-term returns.

Sincerely,

Michael A. Steinberg  
Managing Partner