



Second Quarter 2007 Commentary and Outlook

On the back of stronger than anticipated corporate profits, equity markets posted healthy gains in the second quarter. A weak dollar, combined with concerns about the impact a deteriorating housing market might have on mortgage-related securities, drove outperformance of large-cap stocks compared to small and mid-cap stocks. Slowing economic growth helped growth stocks beat value in all capitalization ranges. Your portfolio posted solid results for the period, both in absolute terms and relative to its benchmark. Exposure to the financials sector contributed most significantly to outperformance as a result of both stock selection decisions and an underweight position in the sector. Stock selection in the industrials sector and an overweighting of the energy sector also benefited relative returns. Stock selections in the consumer discretionary and energy sectors detracted.

Unwinding Global Liquidity

The recent performance of the financial markets has been characterized by a dichotomy in which equities are rising in spite of deteriorating economic fundamentals while bonds, reflecting investors' increasing aversion to risk, have come under pressure. This raises the questions: What is causing this behavior and how long can this set of circumstances persist, where the senior part of the capital structure, reflecting a repricing of risk, underperforms the more junior, equity component which is seemingly oblivious to rising risks?

One plausible explanation is the fact that global liquidity, on all levels, has never been so abundant. We note, however, that the peak rate of growth in liquidity has likely passed, which suggests that the anomalous behavior in the markets may soon resolve itself. Interest rates have begun to rise in earnest on a global basis and lending standards and practices are being tightened, at least partly in response to troubles in the mortgage market. The effect is to reduce the supply of credit and raise the price where it is available. Tighter credit will affect most constituencies in the economy, from the consumer, whose purchases account for a full two-thirds of GDP, to the financial engineers, whose heretofore easily financed LBO transactions provided an underpinning for equity markets. Therefore, it appears reasonable to assume the equity markets may soon become more aligned with developments in the credit markets. The extent of any adjustment is difficult to determine, and is likely to be importantly influenced by the interplay between the housing, capital and currency markets.

Effects of Housing and Currency Weakness

Well-publicized problems in the housing market are creating a growing dislocation in financial markets by eroding the credit value of securities holdings. In the months ahead, this situation may reasonably be expected to further reduce the available supply of credit, which in turn is likely to have a depressing effect on the pace of domestic economic activity. The dollar's strength or weakness may help determine the magnitude of any economic slowing.

The dollar has declined to record low levels against the currencies of many of our most important trading partners. If that situation persists, it may soon cause undesirable effects including rising domestic interest rates, which would further slow the pace of economic activity and make imports more expensive. This, in turn, could lead to slowing economic growth abroad. If the combination of rising interest rates and a slowdown in global economic growth were to occur it is unlikely to be well received by financial markets. Therefore, it will be particularly important in the days and weeks ahead to monitor unfolding events in the housing market and the performance of the dollar.

Portfolio Opportunities

Independent of the near term course of financial markets, we believe we have identified investment opportunities that can thrive in a challenging environment and that offer potential for superior long-term returns. Among these investment opportunities is a well-managed, financially strong, content-rich media company that appears positioned to capitalize on long-tail niche opportunities in emerging markets for digital content. The shares of this company are selling at a meaningful discount to our estimate of the intrinsic worth of the business and offer an extremely attractive risk-reward profile. We expect the company's net asset value to rise significantly in the years ahead as the development of multiple new distribution platforms leads to accelerating free cash flow growth. As the owner of the last large independent film library, the discount between the company's growing intrinsic value and the market price of the equity is unlikely to persist over the long-term.

It is the ability of our team to continue to identify securities which we believe have extraordinary risk-reward profiles that gives us confidence that independent of the inevitable dislocations that will occur in financial markets from time to time, your portfolio should continue to demonstrate superior long-term investment returns.

Sincerely,



Michael A. Steinberg
Managing Partner