



Steinberg Asset Management, LLC

Third Quarter 2006 Commentary and Outlook

On the back of lower oil prices and falling interest rates our equity markets staged a spirited rally in the third quarter. The S&P 500 gained 5.67% while the Russell 3000 Value and Russell 2000 Value Indices returned 5.88% and 2.55% respectively. Positive performance in our portfolios resulted from our energy and materials investments while our investments in the consumer discretionary sector detracted from performance.

Housing may dampen future economic growth

For several years now the US economy has more often than not surprised on the upside. However, in our judgment, this is unlikely to be the case in the coming quarters. A housing led consumer retrenchment appears to be unfolding that may lead to a period of below-trend growth.

Declining housing cycle in early stages

The degree and duration of the housing industry's impact on economic activity is likely to be determined by whether or not the current downside of the cycle is being driven by the end of a speculative bubble, in which case inventories will be brought into balance within a relatively short period of time, or by more fundamental forces related to affordability, in which case the downturn is likely to be more long lasting.

To help put things in historical perspective, prior fundamentally driven housing down cycles lasted up to five years and demonstrated declines between 30% and 50% in existing home sales and approximately 50% in new home sales. The current cycle is only around one year old and has demonstrated a decline of approximately 9% for existing home sales and 16% for new home sales. If history is indeed a good indicator, and the fundamentals of affordability are behind the current softness, today's cooling housing market may get even colder.

Downturn in housing may depress corporate profits

Equity investors pay close attention to the housing sector because it exerts an important influence on the overall pace of economic activity and the level of corporate profits, particularly by influencing consumer spending which accounts for around 65% of GDP. For several years, consumer spending has been fueled by homeowners tapping into, and spending, substantial amounts of their growing equity through second mortgages and refinancing. The absence of further real estate appreciation or declining home equity levels could have a pronounced affect on Mortgage Equity Withdrawals (MEW), which in the second quarter were estimated to be running at an annual rate in excess of \$800 billion (implying the effect of any slowing in MEW has yet to hit the economy). This amount of MEW is equal to around 10% of consumer spending and 6% of GDP.

So if, and or when, Mortgage Equity Withdrawals begin to recede from recent lofty levels we may expect a material slowdown in the rate of consumer spending. And if this slowdown is not offset by a pickup in exports and or corporate/government expenditures, then corporate profits will suffer and this is unlikely to be well received by our equity markets.

Credit availability at increased risk

There is also the risk that rising defaults on home mortgages might reduce the willingness of financial institutions to lend. For example, one respected research firm concluded in a study of potential defaults on ARM's (Adjustable Rate Mortgages) originated in 2004 and 2005 that defaults are likely to total \$300 billion before and \$110 billion after recoveries. Although this loss after recoveries appears small—equal to only 1.2% of all outstanding mortgages in a \$13.2 trillion economy—mortgages now account for a higher share of the assets of commercial banks than ever before. And since there has historically been a reasonably close link between credit quality and bank's willingness to lend, this potential level of losses may translate into less credit broadly available. If this were to occur it could depress the pace of economic activity.

Long-term investment focus

For us, and your portfolio, we will continue to focus on identifying equities of businesses that appear to be selling at prices in relation to their intrinsic worth that limit the risk to capital and hold the potential to produce superior long-term returns. In this regard we would like to highlight a company in the transportation arena that we have recently purchased for portfolios.

This company operates an attractive business that ships goods in and around the U.S. and enjoys a high quality revenue stream derived from supplying essential goods to markets that have no economically competitive sourcing. In addition, the company's available capacity suggests incremental revenues should translate into leveraged earnings gains and we project earnings may rise to the area of \$5.00 per share and perhaps as much as \$10.00 by 2010. Given that earnings equate to free cash flow there should be an extremely rapid build up of equity as this able management team deploys the free cash flow to pay down debt (required debt repayments are minimal). The combination of high quality earnings gains coupled with an increasingly strong financial profile suggests that purchases at around current prices, which we estimate to be in the area of the company's net asset value, have the potential to produce well above average long-term returns.

We continue to believe that building your portfolio around investments such as the above referenced transport company, that we identify as having outstanding risk-reward profiles will produce superior long-term results for patient investors.

Sincerely,

Michael A. Steinberg
Managing Partner