

Third Quarter 2008 Commentary and Outlook

Rapid deleveraging and concerns regarding the stability of the financial system led to extreme volatility throughout the third quarter culminating in a dramatic sell-off in early September, which was followed by the Treasury Department's proposal for the largest government intervention in capital markets since the Great Depression. While equities initially recovered on news of the plan and the announcement that the government would guarantee money market funds against losses, the market resumed its downward trend into the end of the quarter as Congress delayed passage of the plan and investors digested its details and implications.

Treasury Plan Responds to Severe Crisis in Confidence

Since the credit crisis began last summer, the financial system has faced twin risks of illiquidity and insolvency. Lehman Brothers' declaration of bankruptcy on September 15th and the emergency federal loan to American International Group shortly thereafter eroded fragile investor confidence and threatened the liquidity of the financial system. Investors lost faith in money market funds, normally considered a proxy for cash, after one of them "broke the buck" due to exposure to Lehman Brothers' debt. The funding of some short-term commercial paper – essential to the daily operations of scores of companies – halted abruptly. Banks stopped lending to each other and yields on Treasury bills traded below zero, indicating that investors would rather accept negative yields for the safety of Treasuries than risk losses on other types of assets.

Against this backdrop, the Treasury Department proposed spending \$700 billion to remove troubled assets from financial intermediaries' balance sheets. The plan sought to bolster investor confidence, prevent a global run on banks, and promote the resumption of capital flows between financial intermediaries. Its long-term goal was to free banks of troubled assets so that credit could be extended and fresh capital could be infused.

Capital Infusions Remain Critical

Since the start of the credit crisis, the global financial system has sustained more than \$500 billion in write-downs, largely in the United States. A significant portion of the equity lost as a consequence of these asset write-downs has been replaced with fresh capital from sovereign wealth funds, individual investments and corporate transactions. This has helped mitigate the negative impact on credit availability. Looking ahead, the speed with which additional infusions of new equity can be brought into the banking system to replace future capital reductions from asset write-downs and capital losses will heavily influence the longer-term outlook for economic activity and corporate profits, making the success of the government's interventions critically important. We believe that capital constraint in the financial system and a financially strained consumer may result in an extended period of sub-optimum economic growth leading to a prolonged period of anemic growth in corporate profits.

Portfolio Positioning

In prior quarterly letters we have outlined how our investment strategy seeks to position your portfolio to capitalize on opportunities created by global deleveraging. The recent period of market turmoil has clearly been unpleasant, and the view of a portfolio that has been "marked-

to-market” in this environment can be especially disconcerting. However, we believe that your portfolio’s current mark-to-market valuation, while reflecting the value the market places on its holdings on a given day, does not reflect its intrinsic worth. We believe the true values of your portfolio holdings are likely to become apparent as the credit crisis subsides and asset values and earning power are recognized by the market. Please note that in your portfolio:

- There are no permanent losses of capital due to solvency or liquidity issues that businesses could not overcome
- There are no embedded losses from trades gone awry (we are not traders)
- There is no threat of forced liquidation of positions at undesirable prices due to the adverse effect of leverage (we do not employ leverage)

Recognizing Opportunities in Difficult Conditions

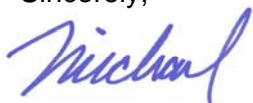
To be sure, the adverse economic effects of the credit crisis will influence the prospects of the vast majority of businesses operating in our economy. In many cases, this is already more than reflected in the recent market decline due in significant part to the adverse effects of the deleveraging process where investors are forced to sell securities to raise capital. The forced sale of the securities of sound businesses depresses their prices to levels where the discount between the intrinsic worth of the business and the market price is unjustifiably large. This should create opportunities for exceptional long-term returns.

Recent unsettling developments in financial markets strengthen the case for our strategy of focusing on companies that:

- Are run by management teams with demonstrated records of capital allocation excellence
- Possess strong financial postures and are not generally characterized by excessive levels of operating or financial leverage

These types of companies appear extremely well positioned to increase market share and acquire assets of strategic value. This combination should translate into significantly enhanced earning power and cash generation which will ultimately benefit you as a long-term shareholder.

Sincerely,



Michael A. Steinberg
Managing Partner